S. HRG. 98-332 Pt. 3

ADMINISTRATION'S FISCAL YEAR 1984 BUDGET PROPOSAL—II

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

JUNE 15, 16, 22, 23, 28, AND 29, 1983

PART 3 OF 4

(June 23 Tax Con.pliance)

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ADMINISTRATION'S FISCAL YEAR 1984 BUDGET PROPOSALS—II

THURSDAY, JUNE 23, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:03 a.m. in room SD–215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Roth, Durenberger, Symms, Long, Bentsen, Baucus, Bradley, and Mitchell.

[The background material on H.R. 1183, Federal income tax compliance, and the prepared statements of Senators Dole, Symms, and Baucus follow:]

[Press Release No. 83–144]

FISCAL YEAR 1984 BUDGET PROPOSALS

Senator Robert J. Dole (R., Kans.), chairman of the Senate Committee on Finance, today announced hearings for June 15, 16, 22, 23, 28, and 29, 1983, on budget proposals for programs within the jurisdiction of the committee.

"The Williamsburg Summit Conference produced a clear message that Congress must act to reduce the projected Federal budget deficits to avoid jeopardizing the global economic recovery." Senator Dole stated, "In my view, the only 1984 budget blueprint that is likely to result in actual reduction of the deficit will be one that places the primary emphasis on spending reductions rather than on tax increases."

"Any new revenue—if needed—should come from tax reform not tax increases. The hearings I am announcing today should assist the Finance Committee in preparing to implement any balanced and responsible budget compromise that may emerge," Senator Dole concluded.

The hearings will begin on each day noted at 10 a.m. in room SD–215 of the Dirksen Senate Office Building.

The following is a schedule of hearings:

TAX COMPLIANCE

The hearing on June 23d will be devoted to possible measures to reduce the $100 billion annual tax compliance gap. The committee will explore the effectiveness of withholding and additional reporting requirements, as well as increased penalties and interest, in encouraging tax compliance. The committee will also be interested in possible changes in the substantive tax laws which may increase compliance. In addition, the committee will address the role of tax professionals, as well as taxpayers, in increased tax compliance efforts.

BACKGROUND ON FEDERAL INCOME TAX COMPLIANCE

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON

JUNE 23, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on June 23, 1983, on Federal income tax compliance issues.

This pamphlet, prepared in connection with the Committee's hearing, contains three parts. First, there is an overview of the income tax compliance provisions established in the Internal Revenue Code. Second, administrative efforts by the Internal Revenue Service to promote compliance are summarized. Third, different approaches toward increasing taxpayer compliance are identified and discussed.

I. PROVISIONS OF PRESENT LAW RELATING TO COMPLIANCE WITH THE FEDERAL INCOME TAX LAWS

A. Overview

The internal revenue laws impose income taxes on individuals, estates, trusts, corporations and other organizations. These taxes are levied and collected under a system of self-assessment which requires taxpayers to file returns reporting income, deductions, credits, and other information necessary to compute tax liability. This system covers foreign as well as domestic transactions.

To assure compliance with the self-assessment system, the tax law imposes a variety of requirements both on taxpayers and on persons making payments to third parties. These include minimum filing requirements, recordkeeping requirements, withholding tax requirements, estimated tax payment requirements, and information reporting requirements. Taxpayers who fail to pay tax or who underpay their tax are subject to interest charges and may incur penalties. Third parties who contribute to the underpayment of tax by others may also be subject to penalties. Similarly, failure to file required information returns and statements may result in imposition of penalties. These requirements and the consequences of noncompliance are described below.

In addition, non-tax reporting requirements are imposed by the Bank Secrecy Act on financial institutions receiving large cash deposits from individuals, and on persons who bring large amounts of cash into or out of the United States.

B. Filing Requirements

Any person subject to any tax, or required to collect and pay over any tax, must make such returns, file such statements and provide such information as may be required by Treasury regulations. Such returns or statements must be according to the forms prescribed, and contain the information required by the Treasury including employer account numbers and employee identification numbers.

1. Individuals

As a general rule, every individual who is a United States citizen or resident who has gross income for the taxable year equal to or greater than the sum of the zero bracket amount applicable to that taxpayer plus the exemption amount ($1,000 under present law, $1,000 increased by a cost-of-living adjustment starting with taxable years beginning in 1985) must file an income tax return, even if the tax has been paid by installment or withholding payments. For example, individuals who are not married and not surviving spouses and who have gross income for the taxable year of $3,300 or more (the sum of the exemption amount, $1,000, plus the zero bracket amount applicable to such an individual, $2,300) must file income tax returns. Similarly, filing is required of individuals entitled to file jointly with their spouses and whose gross income, when combined, is equal to $5,400 (i.e., the zero bracket amount applicable to a joint return ($3,400) plus twice the exemption amount ($2,000)). However, married taxpayers filing separately or living apart have a filing threshold of $1,000. If a taxpayer is entitled to an additional exemption amount for being 65 or over, for example, the filing threshold is increased accordingly. One effect of this exemption system is that in processing income information, the Internal Revenue Service cannot always identify exactly which taxpayers are required to file returns and which are not.

These filing thresholds for individuals do not apply to nonresident alien individuals, United States citizens entitled to the benefits of section 931 with respect to income from sources within United States possessions, individuals making short-year returns with respect to changes in accounting periods, and certain dependents who have unearned income. Such persons are subject to specialized filing rules or may not be required to file at all.

Minors are subject to the same filing requirements as are other individuals unless they could be claimed as a dependent on their parents' return and had unearned income of $1,000 or more, in which case the filing threshold is $1,000. The return of a minor must be made by the minor himself or by his guardian or the persons charged with the care of the minor's person or property.

A tax return may be made by the taxpayer's agent if, by reason of disease or infirmity, the person liable for the return is unable to

make it, or if the taxpayer is continuously absent from the United States (including Puerto Rico) for a period of at least 60 days prior to the return due date. The return may also be made by an agent if the district director determines that good cause exists for permitting the return to be made by an agent.

In general, every nonresident alien individual engaged in a trade or business in the United States at any time during the taxable year, or who has taxable income for the taxable year (unless fully paid by withholding) must make a return of income.

2. Corporations

Every domestic corporation (other than exempt corporations) in existence during any portion of a taxable year must file an income tax return. If a corporation is in existence for only part of a taxable year, it is required to make a return for that part of the taxable year. If an organization is otherwise exempt from tax under section 501(a) (dealing with certain exempt organizations), but is liable for the tax imposed on unrelated business income, it must nonetheless make a return.

In addition, every foreign corporation engaged in a trade or business in the United States at any time during the taxable year or which has income subject to tax for the taxable year (unless fully paid by withholding) must make a return of income.

3. Fiduciaries

The income tax return of taxable estates and trusts must be filed by the fiduciary responsible for the estate and trust. Tax returns are required if the estate or trust has $600 or more of gross income during the taxable year or if any beneficiary of the estate or trust is a nonresident alien. Generally, no income tax return is required for a trust described in section 501(a), unless the trust is liable for the tax on unrelated business income. In addition, certain U.S. beneficiaries of foreign trusts are required to report their interests in the trust, and foreign trusts with U.S. beneficiaries must report.

4. Consequences of failure to file and pay tax, etc.

In general

The Secretary is required to make any inquiries and determinations necessary to assess all taxes imposed under the Internal Revenue Code. If a taxpayer fails to report and pay income, estate, gift, or certain excise taxes due, the Commissioner is authorized to send a notice of deficiency to the taxpayer and to proceed with the various steps preparatory to assessment and collection of the tax.

Various additions to tax, assessable civil penalties and criminal penalties also attend the failure to file a timely, accurate tax or information return or statement and to pay on time any tax due. These include penalties for failure to file or pay tax, for frivolous returns, substantial understatements, negligence and fraud, which are described below. (The separate penalties for failure to collect and pay over withholding taxes are described in Section C.2., below.)

Failure to file return or to pay tax

Any failure to file an income, estate, or gift tax return or to pay the amount shown as tax thereon on the due date (including extensions), may result in an addition to tax. Generally, the penalty for failure to file on time is an addition to tax equal to five percent of the amount of tax required to be shown on the return for each month or fraction thereof that the failure continues, but not in excess of 25 percent. In addition, in the case of a failure to file within 60 days of the date prescribed (with extensions), the minimum penalty for failure to file is not less than the lesser of the amount of tax required to be shown on the return or $100. In 1982, the Senate Finance Committee adopted a minimum penalty on non-filers of $100. This penalty was modified in conference to the form in which it appears in present law. A failure to timely pay the amount shown as tax on a return will result in an addition to tax equal to 0.5 percent of the amount of such tax for each month or a fraction thereof that the failure continues, not exceeding 25 percent. The failure to pay penalty reduces any addition to tax for failure to file. These additions to tax do not apply if the failure to file or pay is due to reasonable cause and not to willful neglect. These penalties do not apply to any failure to pay estimated tax. Those failures are subject to separate penalties. (See D., below.)

There is also an addition to tax for failure to file certain information returns. Any failure to file the information returns required with respect to, for example, interest or dividend payments generally will result in a $50 penalty per failure not to exceed $50,000 for the calendar year. There is a similar penalty for failure to provide a required information statement to the payee. Both penalties are subject to a reasonable cause defense. With respect to most information returns, if the failure to file is due to intentional disregard of the filing requirement, the penalty is not less than 10 percent of the amount not properly reported (5 percent of gross proceeds in the case of brokers) and the $50,000 limitation does not apply.

Further, any person who is required by regulations to furnish his taxpayer identification number to another person, or to include in any return or other document filed with respect to another person the taxpayer identification number of such person, is subject to a $50 penalty for each failure to do so. If a person fails to include his own taxpayer identification number in any return or other document, the penalty is $5 per failure. In any event, the total penalties for all failures to include or provide taxpayer identification numbers cannot exceed $50,000 in any calendar year. This penalty is subject to a reasonable cause exception.

Frivolous returns

An immediately assessable penalty of $500 is imposed on any individual who files any document which purports to be a return of income tax if (1) the document fails to contain information from which the substantial correctness of the amount of tax shown on the return can be judged or contains information that on its face indicates that the amount of tax shown on the return is substantially incorrect, and (2) such conduct arises from a position taken

by the taxpayer on the purported return which is frivolous, or from a desire (which appears on the face of the purported return), to delay or impede the administration of the Federal income tax laws. This penalty is an addition to all other penalties provided by law.

Substantial understatement of tax liability

When there is a substantial understatement in income tax for any taxable year attributable to a filing position not disclosed by the taxpayer in the return, or for which the taxpayer did not have substantial authority, an addition to tax equal to 10 percent of the understatement is imposed.

For this purpose, an understatement of income tax is the excess of the amount of income tax imposed on the taxpayer for the taxable year, over the amount of tax shown on the return. An understatement of income tax is substantial if the understatement for the taxable year exceeds the greater of 10 percent of the tax required to be shown on the return for the taxable year or $5,000 ($10,000 for corporations other than S-corporations and personal holding companies.)

In determining whether an understatement is substantial, the amount of the understatement is reduced by any portion of the understatement attributable to the treatment of any item if (1) the treatment of the item on the return is or was supported by substantial authority or (2) in non-tax shelter cases, all of the facts relevent to the tax treatment of the item were disclosed on the return or in a statement attached to the return.

With respect to tax shelter items, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. For this purpose, a tax shelter is a partnership or other entity, plan or arrangement the principal purpose of which, based on objective evidence, is the avoidance or evasion of Federal income tax.

In 1982, the Senate Finance Committee provision relating to substantial understatements did not contain the substantial authority defense. Thus, the taxpayer would have been required to have a reasonable belief that his position was more likely than not correct in all cases. This substantial authority defense in non-tax shelter cases was adopted on the Senate floor.

The Secretary may waive the penalty with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith.

Finally, this penalty applies only to that portion of the substantial understatement attributable to items on which the overvaluation penalty under section 6659 is not imposed.

Addition to tax for valuation overstatements

A penalty, as a percentage of the underpayment, is imposed (on individuals and certain corporations), with respect to any underpayment of income tax attributable to a valuation overstatement. A valuation overstatement for this purpose is any valuation of property (or the adjusted basis of property) claimed on a return which is 150 percent or more of the correct value or adjusted basis

of the property. The percentage penalty ranges from 10 percent of the underpayment attributable to the overstatement for valuation overstatements from 150 percent to 200 percent, to 30 percent of the underpayment for valuation overstatements in excess of 250 percent.

The penalty is not imposed if the property has been held by the taxpayer for over five years or the underpayment attributable to the valuation overstatement is less than 1,000.

This penalty is, in effect, a strict liability penalty. The Secretary may waive the penalty on a showing by the taxpayer that there was a reasonable basis for the value claimed and that such claim was made in good faith.

Negligence

If any part of an underpayment of income, gift, or windfall profit tax is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there is added to the tax an amount equal to 5 percent of the total underpayment. In addition, there is added to the tax an amount equal to 50 percent of the interest payable with respect to that portion of the underpayment attributable to negligence or intentional disregard of rules and regulations for the period from the last day prescribed for payment of the tax. (without regard to extensions), to the earlier of assessment or payment of the tax.

Fraud

If any part of an underpayment of any tax is due to fraud, there is added to the tax an amount equal to the sum of 50 percent of the entire underpayment plus 50 percent of the interest payable on the portion of the underpayment attributable to fraud for the period beginning on the last day prescribed for payment of the tax (without regard to any extension), and ending on the earlier of the date of assessment or the date of payment of the tax. In the case of any income, gift or windfall profit tax, the negligence penalty does not apply if the fraud penalty applies. In addition, if a fraud penalty is assessed for any underpayment, no penalty for failure to file or pay tax will be assessed for that underpayment. In addition to the 50-percent civil fraud penalty, criminal penalties may apply. (See below.)

Recordkeeping requirements

Taxpayers are required to keep such records as the Secretary may from time to time require including such records as may be necessary to allow the taxpayer to make an accurate return of income.

With respect to the amount of tips paid to a particular employee, the only records of charged tips which an employer can be required to keep under section 6001 are charge receipts and copies of statements furnished by employees under section 6053(a). Accordingly, an employer is required to keep charge receipts (which receipts reflect the amount of tips included by the customer in the charged amount), but is not presently required to record on such charge receipts, or otherwise keep records of the name of any particular em-

ployee to whom the charge tip amount is paid over by the employer.

This recordkeeping limitation relates to records of amount of such tips paid over to a particular employee and does not affect any other recordkeeping requirements which may be applicable to the employer under section 6001 (e.g., for purposes of determining the employer's own income tax liabilities). Nor does it affect any recordkeeping, reporting, or return requirements imposed on employers pursuant to section 6051 with respect to tips included in statements furnished by employees to the employer pursuant to section 6053(a).

Failure to comply with such recordkeeping requirements may, in the event of an underpayment of tax, subject the taxpayer to a five percent penalty.

Jeopardy and termination assessments

In addition to the normal deficiency procedure which is available to the Internal Revenue Service for the collection of underpayments, the Internal Revenue Service has other tools at its disposal for the collection of tax, including the jeopardy and termination assessment procedures.

The Secretary may make a jeopardy assessment of income, estate, gift, and certain excise taxes if he determines that there is a tax deficiency the collection of which would be jeopardized by delay. In the case of a jeopardy assessment, the Secretary may immediately assess and collect such deficiency, together with all interest, additional amounts, and additions to tax provided for by law. A jeopardy assessment may be made at any time prior to the earlier of a final decision of the Tax Court or the appeal of a Tax Court decision. There are provisions for the abatement of any jeopardy assessment and for review of the assessment.

The Secretary may make a termination assessment if he finds that a taxpayer intends to do any act tending to render proceedings to collect the income tax for the current or immediately preceding taxable year ineffectual. When a termination assessment is made with respect to the current taxable year, the Secretary must treat the taxable year as terminated as of the date of the determination and treat that portion of the taxable year as if it were an entire taxable year. The amount assessed is due and payable immediately. Both jeopardy and termination assessments are subject to review by the Tax Court. The Secretary may not make a termination assessment for the taxpayer's preceding taxable year after the due date for that year's return.

The Secretary can presume that the collection of an amount of income tax is in jeopardy when an individual in physical possession of more than $10,000 of cash or of an equivalent medium of exchange denies ownership of the cash and does not claim that such cash belongs to another person the identity of whom is readily ascertainable by the Secretary (and who acknowledges ownership). In such a case, the Secretary may presume, for purposes of the jeopardy or termination assessment provisions (1) that such cash represents gross income to a single individual for the taxable year of possession taxable at a 50 percent rate, and (2) that the collection

of the tax on such cash would be jeopardized by delay. The Internal Revenue Service cannot assess on the same cash twice.

Criminal penalties

There are certain criminal penalties which may attend a failure to file an income tax return as required or to pay a tax when due. For example, any person who willfully attempts to evade or defeat any tax is guilty of a felony and is subject to a fine of not more than $100,000 ($500,000 for corporations), or imprisonment for not more than 5 years, or both. If a person is required to pay a tax, to make a return, to keep any records, or to supply any information and that person willfully fails to do so, then that person generally is guilty of a misdemeanor and is subject to a fine of not more than $25,000 ($100,000 for corporations), or imprisonment for not more than one year, or both. The penalty for perjury on a tax return is a fine of not more than $100,000 ($500,000 for corporations), or imprisonment for not more than 3 years, or both. A person who willfully aids, counsels or advises the preparation of a fraudulent return or other document, is guilty of a felony and may be subject to a fine of not more than $100,000 ($500,000 for corporations) or imprisonment for not more than three years, or both.

C. Withholding and Withholding Noncompliance

1. Withholding requirements

Under present law, an employer who pays wages to individual employees must withhold a portion of such wages to satisfy all, or part, of the employee's Federal income and social security tax liability. The term "wages" generally is defined as all remuneration, unless specifically excluded, paid for services performed by an employee for an employer, including the cash value of all remuneration paid in any medium other than cash. The amount to be withheld from the wages of a particular employee is determined in accordance with tables prescribed by the Secretary.

Besides the obligation on employers to withhold the employee's income and social security taxes from wages paid to the employee, present law contains a variety of other withholding requirements. These include withholding on certain items of income to foreign persons where the items are not effectively connected with a U.S. trade or business or are compensation for personal services; gambling winnings; payments of interest, dividends, or patronage dividends; and backup withholding payments where no taxpayer identification number (TIN) is received (or an erroneous TIN is not corrected).

Wage withholding exemptions

Individuals whose wages are subject to withholding may be entitled to exempt them from withholding in $1,000 increments (exemptions). The exemptions allowed include (1) one exemption for the taxpayer; (2) one additional exemption for the taxpayer who has attained, or will attain, age 65 during the taxable year; (3) one additional exemption if the taxpayer is blind; (4) an exemption for the taxpayer's spouse (and additional exemptions for age or blindness of the spouse) unless the spouse is claiming such exemptions on a separate return; (5) one additional exemption for each dependent of the taxpayer; and (6) a zero bracket amount allowance, unless the taxpayer is married and the spouse receives wages subject to withholding or the taxpayer has withholding exemption certificates in effect with respect to more than one employer. In addition to these withholding exemptions, taxpayers may be entitled to claim additional withholding exemptions for excess itemized deductions, tax credits and additional items specified in Treasury Regulations.

An individual subject to withholding may reduce or increase the number of exemptions claimed (under procedures set forth in the regulations) so that withheld taxes will more closely equal his or her anticipated tax liability. Employees who incurred no income tax liability for the preceding taxable year and expect to have no

income tax liability for the current taxable year may claim total exemption from wage withholding.

Wage withholding exemption certificates

An individual may claim withholding exemptions by furnishing his or her employer with a withholding exemption certificate (Form W–4). In the case of new employment, this certificate must be furnished when or before employment begins. If no exemption certificate is furnished, the employee is considered as unmarried and claiming no exemptions.

When a change occurs which decreases the number of withholding exemptions which an employee is entitled to claim, the employee must furnish the employer with a new exemption certificate reflecting the correct number of exemptions. Such new certificate must be furnished within ten days after the change occurs. In addition, a new certificate is required when an employee who has claimed complete exemption from withholding can no longer reasonably anticipate a zero income tax liability for the current taxable year.

An employer is required to submit to the Internal Revenue Service a copy of a withholding exemption certificate received from an employee during the reporting period if (1) on the last day of the reporting period, the employee is employed by that employer and claims more than fourteen withholding exemptions, or (2) the employee claims complete exemption from withholding unless the employer reasonably expects that the employee's wages from the employer will not usually exceed $200 a week.

Withholding from pensions, annuities, and certain other deferred income

In general, withholding is required under section 3405 from the taxable portion of any distribution or payment (*i.e.*, any designated distribution) from or under an employer deferred compensation plan, an individual retirement plan (as defined in section 7701(a)(37)), or a commercial annuity, unless the payee elects, in writing, not to have withholding applied to the designated distribution. The payor of a designated distribution is required to provide a payee with notice of the right to elect not to have the withholding rules apply. This notice must contain a statement that the payee may be subject to penalties if he elects out of withholding and fails to make sufficient estimated tax payments during the year.

The amount required to be withheld depends upon whether a designated distribution is a periodic payment, a nonperiodic distribution, or a qualified total distribution. Periodic payments are subject to withholding based on the tables for withholding from wages, treating the payee as a married individual claiming three withholding allowances (unless the payee has filed a withholding certificate (Form W–4P) claiming different status). Nonperiodic distributions are subject to withholding at a 10 percent rate. The amount to be withheld from a qualified total distribution is determined under tables prescribed by the Secretary.

Withholding on gambling winnings

In certain circumstances, proceeds from wagers are subject to withholding at a rate of 20 percent. In general, gambling winnings are subject to withholding if the proceeds exceed $1,000 and are at least 300 times as large as the amount wagered. However, special rules apply to winnings from State-conducted lotteries and winnings from sweepstakes, wagering pools, certain parimutuel pools, jai alai, and other lotteries.

The payor of gambling winnings that are subject to withholding is required to file Form W-2G with the Internal Revenue Service center serving the district in which the principal place of business of the person filing the return is located.

Withholding on foreign investors

In general, the United States taxes U.S. source income of a nonresident alien or foreign corporation which is not effectively connected with the conduct of a trade or business in the United States (or which is compensation for personal services) at a flat rate of 30 percent (or a lower treaty rate) of the gross amount paid. This tax is collected through withholding by the person making the payment to the foreign recipient. Income effectively connected with a U.S. trade or business is not subject to the flat 30-percent withholding tax, but instead is includable in the U.S. income tax return of the business and is taxed at the regular graduated rates.

Certain noneffectively connected U.S. source income is exempt from U.S. tax, and therefore from withholding. For example, interest from bank deposits is generally exempt from U.S. tax. Banks have only a minor burden in policing the identify of persons who claim foreign status, however, there is no requirement that payors of interest to persons claiming foreign status report such payments to the Internal Revenue Service. Also, the income of foreign governments from investments in the United States in bonds, stocks, and other securities, or from interest on bank deposits, is exempt from U.S. tax.

Withholding on interest, dividends, and patronage dividends

In general, withholding at a rate of 10 percent is required on any payment of interest, dividends, or patronage dividends paid or credited after June 30, 1983, unless an exception to withholding applies. Exceptions are made with respect to payments to exempt individuals (certain low-income or elderly individuals, and certain simple trusts), exempt recipients (e.g., corporations, tax-exempt organizations, etc.), minimal interest payments (payments of interest which do not exceed $150 if annualized), and qualified consumer cooperative payments.

In general, exemption certificates must be filed by exempt individuals or exempt recipients receiving payments of interest, dividends, or patronage dividends who wish such payments to be exempted from withholding. However, payors may treat certain payees as exempt even though no exemption certificate for that payee has been filed. For example, if the name of the payee contains an unambiguous expression of corporate form, the payor may treat that person as exempt.

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In May 1983, the House of Representatives passed H.R. 2973, which would repeal mandatory withholding on interest and dividends. On June 16, 1983, the Senate passed H.R. 2973 with an amendment which would repeal mandatory withholding on interest and dividends and apply special backup withholding rules to such payments. In light of these developments, on June 16, 1983, the Treasury Department announced a one-month moratorium in enforcing the present law mandatory withholding provisions.

Backup withholding

Under present law, backup withholding at a rate of 15 percent of the amount of the payment may be imposed on a wide range of payments (including payments of interest, dividends, and patronage dividends to payments to nonemployees and certain payments in the course of a trade or business). Backup withholding may be imposed with respect to any such payment if the payee of such payment fails to furnish his taxpayer identification number to his payor, or furnishes an incorrect number and the payor is notified to withhold by the Secretary. Withholding may be required with respect to a payment even though that payment is less than the reporting threshold for such payments.

2. Consequences of withholding noncompliance

Any person liable to withhold out of wages or payments of interest, dividends, or patronage dividends who fails to do so, is liable for the amount of tax not withheld. However, in the case of withholding on interest, dividends, or patronage dividends, the payor is not so liable if the tax is paid by the payee. In addition, any person required to collect and pay over any tax who willfully fails to do so or who willfully attempts to evade or defeat the tax is liable for a penalty equal to the total amount of the tax evaded, not collected, or not accounted for and paid over.

Any person required to deposit a tax by a prescribed date who fails to do so, or any person who makes an overstated deposit claim, is subject to a penalty equal to 5 percent of underpayment or 25 percent of the overstatement, as the case may be, unless the failure or overstatement was due to reasonable cause and not willful neglect.

Any person who is required to furnish certain information to employees with respect to withholding of tax, and who willfully fails to do so or furnishes a false or fraudulent statement, is liable for a penalty of $50 for each failure. In addition, such a person may be subject to a criminal penalty of up to $1,000 or may be imprisoned for not more than one year, or both.

Further, any individual who makes a false withholding statement (with respect to wage withholding, or interest, dividend, or patronage dividend withholding) may be subject to civil penalty of $500, (1) if such statement results in a decrease in the amount deducted and withheld, and (2) if at the time the statement was made there was no reasonable basis for such statement. The Secretary may waive this penalty (in whole or in part) if the taxes imposed on the individual are equal to or less than the sum of his credits against taxes and payments of estimated taxes. Such individual may also be subject to a criminal penalty of not more than $1,000 (in the case of wage withholding), or $500 (in the case of interest, dividend, or patronage dividend withholding), or imprisonment of not more than 1 year, or both.

D. Estimated Tax

1. Corporations

Any corporation subject to tax is required to make payments of estimated tax if it reasonably expects to have a tax liability for the taxable year of $40 or more. The estimated tax is payable in up to four installments over the taxable year. In general, if the estimated tax payments for the taxable year are not at least 90 percent of the actual tax due, then a penalty is imposed as an addition to tax. This penalty equals the amount of interest which would accrue on the amount of the underpayment of estimated tax during the period of the underpayment. Generally, this addition to tax does not apply with respect to any installment if, on or before the date prescribed for such installment, the corporation pays the amount which would have been due on that date if the estimated tax were the lesser of:

(1) The corporation's prior year tax liability;

(2) the corporation's tax liability on prior year's income computed using tax rates for the current year; or

(3) 90 percent of the taxes which would have been due if the income which the corporation had already received during the current year had been computed on an annualized basis.

In addition, a special exception applies with respect to corporations (including large corporations) having recurring seasonal income. If a corporation pays 80 percent of the total tax due instead of 90 percent, the penalty is reduced by 25 percent.

In 1983, large corporations (those with taxable income of $1,000,000 or more during any of the three previous taxable years) otherwise qualifying under either of the first two safe harbors will not be subject to the addition to tax if their estimated tax payments for the taxable year are at least 75 percent of the tax shown on their returns for the taxable year. In taxable years beginning in 1984 and thereafter a large corporation must generally pay at least 90 percent of the taxes which would have been due if the income which the corporation had already received during the current year had been computed on an annualized basis to avoid penalty.

2. Individuals

Individuals must also pay estimated tax. In general, a single person, or a married couple with one wage earner, whose gross income is expected to exceed $20,000 for the taxable year is required to pay estimated tax. A married individual entitled to file a joint return with his spouse, whose gross income is expected to exceed $10,000 for the taxable year, and whose spouse also receives wages is also liable to pay such tax. Finally, a married individual not entitled to file a joint return with his or her spouse, whose gross income is expected to exceed $5,000, must pay estimated tax.

In any event, an individual who expects to receive more than $500 from sources other than wages during the year must pay estimated tax. Regardless of the taxpayer's estimated income, however, no payment of estimated tax is required if it is anticipated that the taxpayer's estimate tax liability for the year will be less than $300 ($400 for 1984, and $500 for 1985 and thereafter).

An individual who fails to pay an amount of estimated tax due on or before the due date may be subject to a penalty. The penalty is equal to the amount of interest which would accrue on the underpayment during the period of the underpayment. In general, an underpayment for this purpose is equal to the difference between the payments (including withholding) made on or before the due date of each installment and 80 percent of the total tax shown on the return for the year, divided by the number of installments that should have been paid. The penalty is not subject to a reasonable cause defense.

There are four exceptions to the general penalty for underpayment of estimated tax which also operate to define the amount of estimated taxes due for the taxable year. No additional estimated tax payment is required and no underpayment penalty is imposed upon a taxpayer if total payments on or before any installment due date equal or exceed: (1) the amount due if the current year's tax equaled the tax shown on the preceding year's return, or the preceding year's tax liability, if a return showing a liability for tax was filed for the preceding year and such year was a full taxable year of 12 months; (2) 80 percent (or 66⅔ percent for farming or fishing income) of the taxes which would be due if the income already received during the current year were placed on an annual basis; (3) 90 percent of the tax which would be due on the income actually received from the beginning of the year to the computation date; or (4) the amount due at current year's rates and exemptions, but otherwise based on the preceding taxable year's law and income.

For taxable years beginning in 1985 and subsequent years, no penalty will be imposed upon an individual for failure to pay estimated tax if the tax shown on the individual's return (or, if no return is filed, the tax) is less than $500 (without regard to the credit for wages withheld). This exception to the penalty for failure to pay estimated taxes is phased in in the same manner as the increase in the tax liability threshold described above.

E. Information Reporting

1. Information at source generally

Under present law, persons engaged in a trade or business, and the United States, must generally file information returns with respect to payments aggregating $600 or more in any taxable year. These returns are intended to inform the Internal Revenue Service that specified items have been disbursed by the payor so that the Service can determine whether the recipient of the item has treated it properly for tax purposes.[1] This reporting requirement, subject to certain exceptions, applies to various payments including rent, salaries, wages, or other forms of compensation for services, and other fixed or determinable gains, profits, and income, regardless of medium in which payment is made.

These information returns are required to be filed annually and generally must contain the name, address, and tax identification number of the recipient of the payment. Likewise, the payor must furnish the recipient with a written statement showing the payor's name, address, and taxpayer identification number, and the aggregate amount of payments shown on the return. Such statement must be furnished to the recipient on or before January 31 of the year following the calendar year for which the return was made.

If, in the course of a trade or business, any person for whom services are performed pays an aggregate of $600 or more to any person for such services in any calendar year, the payor must file an information return with the Secretary. Such information return must state the aggregate amount of such payments to any recipient and the name and address of such recipient. If any person, (1) sells (in the course of a trade or business), consumer products to any buyer on a buy-sell, deposit-commission, or similar basis for resale in the home (or otherwise than in a permanent retail establishment), and (2) the aggregate sales to any buyer during the calendar year equals or exceeds $5,000, the seller must file an information return with the Secretary. Such returns must set forth the name and address of the buyer, and such other information as may be required by regulations. In either case, information statements with respect to such payments or sales must be furnished to each person with respect to whom a return is filed. (See also 7. below.)

Generally, amounts paid to employees, regardless of whether they are subject to witholding, are not reportable on the usual information return (Form 1099). Instead, those amounts are reportable on information returns (Forms W–2) which relate to payments to employees.

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[1] The Internal Revenue Service's Information Returns Progrm (IRP) matches the information returns filed with respect to payments to some individuals with their income tax returns to detect nonfiling or underreporting of income.

Partnerships are required to file returns for each taxable year stating such items as the Secretary may prescribe, including items of gross income and deductions, and the name and addresses of each individual partner and the amount of that partner's distributive share. If the partnership fails to file such a return, or files an incomplete return, it is liable for a penalty equal to $50 per partner per month (for not more than 5 months) that the failure continues, unless the failure is due to reasonable cause. In addition, a criminal penalty may apply.

Various reporting requirements are also imposed upon the other entities, including custodians of common trust funds, exempt organizations, officers of foreign personal holding companies, and S-corporations.

2. Payments of dividends

In general, every person who makes dividend payments to another person which aggregate $10 or more in a calendar year, who receives dividend payments as a nominee and who makes payments aggegating $10 or more during any calendar year to any other person with respect to the dividends so received, or who is required to withhold tax on any payment of dividends, must file information returns with the Secretary. In the case of the payment of dividends aggregating less than $10, the requirement of information reporting (other than with respect to amounts withheld), is discretionary with the Secretary.

Dividend information returns must be filed with the Internal Revenue Service after September 30 for any calendar year (but not before the payor's final dividend payment for that year), and on or before February 28 of the following year. The returns must set forth the aggregate amount of dividend payments, the amount of withholding (if any), and the name, address and taxpayer identification number of the person to whom paid.

In addition to filing information returns with the Internal Revenue Service, payors of dividends (or nominees) making payments of dividends (or payments with respect to dividends) aggregating $10 or more during any calendar year also must furnish statements to recipients of the dividends. These statements must set forth the name and address of the payor of the dividends and the aggregate amount of payments made to the dividend recipient. Such a statement must be furnished to a dividend recipient no later than January 31 of the year following the dividend payment.

For purposes of this information reporting requirement, the term "dividend" means any distribution made by a corporation which is a dividend under section 316 of the Code. The term dividend also includes any payment made by a stockbroker to any person as a substitute for a dividend, for example, a payment made to the lender of stock in connection with a short sale.

The dividend reporting requirements generally do not apply to distributions or payments made by foreign corporations, or to distributions or payments made to foreign corporations, nonresident aliens, or partnerships not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens.

If the payor is unable to determine what portion of a payment represents a dividend or is paid with respect to a dividend, then, for purposes of the information return requirements, the entire amount of the payment is considered to be a dividend or a payment with respect to a dividend.

3. Payments of interest

Under present law, every person making a payment of interest, including deemed payments of original issue discount, aggregating $10 or more in any calendar year, who receives a payment of interest as a nominee and who makes payments with respect to such interest aggregating $10 or more in any calendar year, or who withholds tax on any payment of interest, must file an information return with the Secretary. Such return must set forth the aggregate amount of such payments, the amounts withheld, if any, and the name and address of the person to whom paid or from whom withheld.

Under present law, original issue discount is treated as a payment of interest at the time the discount is includible in income, without regard (in the case of a long-term obligation) to any reduction in the amount of original issue discount actually includible in income which results from a purchase of the obligation at a price in excess of the issue price plus accrued original issue discount. In the case of original issue discount on a bearer obligation issued before January 1, 1983, and original issue discount which is not includible in the income of a holder periodically (because, for example, the obligation has a maturity of one year or less), the original issue discount is treated as paid on the earlier of redemption or maturity of the obligation. Similarly, acquisition discount on short-term government obligations (which is also treated as interest for tax purposes) is treated as paid at the earlier of redemption or maturity of the obligation. Under these rules, the amounts reported with respect to holders of original issue discount obligations could be different from the amount, in fact, includible in the payee's income.

Reportable interest includes (1) interest on any obligation (other than any obligation with a maturity at the time of issue of not more than 1 year which is held by a corporation) which is issued in registered form or which is of a type offered to the public; (2) interest on deposits with persons carrying on the banking business; (3) amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares; (4) interest on amounts held by an insurance company under an agreement to pay interest thereon; (5) interest on deposits with brokers as defined in section 6045(c); (6) interest paid on amounts held by investment companies and on amounts invested in other pooled funds or trusts; and (7) to the extent provided in regulations prescribed by the Secretary, any other interest (which is not specifically excluded from the definition of interest).

Interest subject to reporting does not include interest on obligations issued by natural persons; interest on exempt governmental

obligations; and, except to the extent otherwise provided in regulations, generally any amount paid to a person who qualifies as an exempt recipient for purposes of the withholding provisions.

4. Employee tips

Under present law (sec. 6053(a), an employee who receives and retains tips of $20 or more in a month, including charge tips paid over to the employee by the employer, must report such tips to his or her employer by the tenth day of the following month. In turn, employers are required to report as wages subject to income tax withholding and social security withholding only the tips actually reported to them by their employees pursuant to section 6053(a).[2] If an employee fails to report any amount of such tips which are wages or compensation to his or her employer, a penalty is imposed on the employee equal to 50 percent of the social security or railroad retirement tax, as the case may be, imposed with respect to the amount of the tips which he failed to report.

Section 6041 (which requires every employer of an employee earning $600.00 or more yearly to report the total of that employee's earnings to the Internal Revenue Service) specifically provides that the information reporting requirements of that provision do not apply to tips reportable under section 6053(a). Accordingly, the only employee tips which an employer must report to the Internal Revenue Service are those reported to the employer by employees on statements furnished pursuant to section 6053(a).

As a result of changes enacted in 1982, each large food or beverage establishment also is required to report annually to the Internal Revenue Service (1) the gross receipts of the establishment from food or beverage sales (other than receipts from carryout sales and mandatory 10-percent or greater service charge sales), (2) the amount of aggregate charge receipts (other than receipts from carryout sales and 10-percent or greater service charge sales), (3) the aggregate amount of tips shown on such charge receipts, (4) reported tip income together with mandatory service charges of less than 10 percent to the extent paid to employees as wages, and (5) any amount allocated to tipped employees under the 8 percent rule described below.

If tipped employees of large food or beverage establishments voluntarily report tips aggregating 8 percent or more of gross receipts (defined as gross receipts from the sale of food or beverages less carryout sales, less 10-percent or greater service charge sales), then no tip allocation needs to be made. However, if this 8-percent reporting threshold is not met, the employer must allocate (as tips for reporting purposes) an amount equal to the difference between 8 percent of gross receipts and the amounts reported by employees for the year to all tipped employees pursuant to either an agreement between the employer and employees or, in the absence of such an agreement, according to Treasury regulations. The employ-

[2] If, because of tip-splitting or tip pooling, the amount of charged tips reported by an employee on his or her Federal income tax return differs from the amount of charged tips reported by the employer for that employee on Form W-2, the IRS rulings permit the employee to attach an explanation of the difference to his or her income tax return.

er has no liability to employees in connection with any dispute regarding allocations of amounts under this rule.

Regulations under the 8-percent provision provide procedures under which a particular establishment, or type of establishment, can show that its tipped employee's average tip rate is less than 8 percent (but not less than 5 percent) of gross receipts. Subject to the Secretary's discretion, such establishments may allocate based on such lower amount as the Secretary may prescribe.

The allocation of the excess of the 8-percent amount over reported tips among tipped employees is solely an information reporting device designed to detect underpayments of tax. This reporting requirement cannot increase or decrease the employer's FICA, FUTA, or income tax withholding responsibilities or the employee's income tax liability.

5. Pensions, IRAs, and annuities

General rules

An information return generally is required with respect to a distribution made to an employee or the employee's beneficiary under a pension, profit-sharing, or stock bonus plan (whether or not tax sheltered annuity program), or a tax-shelter annuity program maintained by an eligible tax-exempt organization or educational institution, if the amount of the distribution which is includible in the recipient's income totals $600 or more for the calendar year (sec. 6041(a)).[8] However, a separate reporting requirement applies to distributions from a tax-qualified plan which benefits an owner-employee (a sole proprietor or a partner whose partnership interest exceeds 10 percent). An information return is required with respect to any owner-employee (or beneficiary of an owner-employee) to whom distributions totaling $10 or more are made during the calendar year, without regard to the amount includible in the recipient's income (sec. 6047).

The trustee or custodian of an individual retirement account or the issuer of an individual retirement annuity (IRA) is required to provide the individual on whose behalf the account or annuity is established (or the individual's beneficiary) an annual report with regard to the status of the account or annuity, including the amount contributed for the years. For 1983 and later years, a copy of this report is required to be furnished to the IRS. Distributions from an IRA are required to be reported by information return to the Internal Revenue Service without regard to the amount of the distribution (sec. 408(i)).

When a United States retirement bond purchased for an employee under a tax-qualified bond purchase plan (sec. 405) is redeemed by the employee or the employee's beneficiary, the Bureau of the Public Debt reports the payment of the redemption proceeds to the Internal Revenue Service. Similarly, when a United States individ-

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[8] In the case of a tax-qualified plan, this requirement for an information return applies not only with respect to amounts actually distributed, but also to any amount includible in the income of an employee as an amount paid to provide the employee current life insurance protection (sec. 72(m)(3)). In addition, an employer who provides group-term life insurance for employees is required to separately report any part of the cost of such insurance which is included in an employee's income (sec. 6052). Generally, the cost of the first $50,000 of group-term life insurance provided by an employer is excluded from the employee's income (sec. 79).

ual retirement bond (sec. 409) is redeemed, the Bureau reports the payments of the redemption proceeds to the Internal Revenue Service.

The issuer of a life insurance or annuity contract not purchased for an employee under a tax-qualified plan or tax-sheltered annuity program generally is required to file an information return with respect to amounts paid to an individual under the contract, if the payments to the individual total $600 or more for the calendar year (sec. 6041(a)). This reporting requirement does not apply, however, to amounts paid by reason of the death of the insured or to amounts paid upon the contract's surrender.

Amounts subject to pension or annuity withholding

The Tax Equity and Fiscal Responsibility Act of 1982 added additional reporting requirements for all designated distributions (*i.e.*, the taxable part of payments made from or under a pension, profit-sharing, stock bonus, or annuity plan, an employer deferred compensation plan if the payments are not otherwise considered wages, an IRA, or a commercial annuity contract). Under regulations prescribed by the Secretary of the Treasury, (1) the employer maintaining, or the plan administrator of, a plan or (2) the issuer of a contract from which a designated distribution may be made shall provide certain information to the Secretary, to the plan participants and beneficiaries, and to any other persons the Secretary requires. In addition to the name, address, and social security number of the participant or payee (and spouse or other beneficiary if applicable), this information includes such items as the total amount of the distribution, the amount of accumulated deductible employee contributions, the amount of nondeductible employee contributions, the amount eligible for capital gains treatment, the amount subject to ordinary income treatment, and the cost basis of any employer securities included in a distribution. This reporting requirement applies without regard to the amount of the distribution.

In the case of an insurance or annuity contract, the reporting requirement applies to amounts paid by reason of the death of the insured and to amounts paid upon surrender of the contract. In addition, an exchange of insurance contracts under which a designated distribution may be made (including a section 1035 tax-free exchange) is a reportable event even though no designated distribution occurs in the particular transaction. The issuer of the contract to be exchanged must, therefore, provide the required information to the policyholder and to the issuer of the new contract.

6. Transactions by brokers

Under present law (sec. 6045), every person doing business as a broker (including a barter exchange) must, when required by regulations, make a return showing customer's names, together with details regarding the customer's gross proceeds and such other information as may be required by forms or regulations. Under TEFRA, the Secretary was required to issue regulations requiring reporting to brokers with respect to securities and commodities. These regulations, which were promulgated in final form on March

3, 1983, apply to transactions by brokers occurring after July 1, 1983.

7. Independent contractors

In general, individuals receiving compensation must be classified as either employees or independent contractors. The classification of individuals as either employees or independent contractors is important because a certain amount of wages paid to employees is generally subject to (1) social security taxes imposed on the employer and the employee under the Federal Insurance Contributions Act (FICA) and (2) unemployment taxes imposed on the employer under the Federal Unemployment Tax Act (FUTA). In addition, Federal income tax must be withheld from compensation paid to employees while payments to independent contractors are not subject to such withholding. On the other hand, compensation paid to independent contractors is subject to the tax on self-employment income (SECA).

The information reporting and withholding rules applicable to employees are reviewed above. A service-recipient (*i.e.*, a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the Internal Revenue Service an information return reporting such payments (and the name, address, and identification number of the recipient) if the remuneration paid to the person during the calendar year is $600 or more. Also, the service-recipient must furnish to the person receiving such payments a statement setting forth the name, address, and identification number of the service-recipient, and the aggregate amount of payments made to the payee during the year.

In addition, any person engaged in a trade or business who in the course of such trade or business sells consumer products on a buy-sell basis, deposit-commission basis, or any similar basis for sale in the home or otherwise than in a permanent retail establishment must report with respect to gross purchases by any buyer of $5,000 or more of such products in any calendar year. Any return filed under this reporting requirement must set forth the name, address, and identification number of the buyer. The seller also must furnish the buyer with a statement setting forth the name, address, and identification number of the seller. In either of those two cases, the service-recipient or seller is also required to report commissions and other remuneration under the reporting provisions generally applicable to such payments.

Because there is no Federal income tax withholding with respect to nonwage income, independent contractors may be required to pay estimated income tax under the rules discussed above.

8. Currency transactions

In addition to the information reporting required by the Code, the Bank Secrecy Act authorizes the Secretary to require reporting of certain financial transactions.

Under these rules, certain banks and other financial institutions are required to report cash transactions (including deposits and withdrawals) of more than $10,000. The Treasury regulations pro-

vide a number of exceptions to this reporting requirement. Also, persons who bring or send more than $5,000 in cash or other bearer instruments into or out of the United States must report the event to the United States Customs Service. Finally, a United States taxpayer who files a tax return is required to notify the Internal Revenue Service, where provided for on the tax return, of the existence of a foreign bank account or other foreign financial account that he controls or in which he has an interest. If the amount in the account is over $1,000 then the amount must be reported on a separate form to the Treasury Department.

Bank Secrecy Act information is compiled by the Treasury Department, and made available to agents of the Internal Revenue Service.

9. Penalties relating to information reporting

As indicated earlier, the Code requires the filing of a variety of information returns with the Internal Revenue Service. Generally, these returns relate to payments to, and transactions with, other persons. The penalty for failure to file most information returns is $50 per return, subject to a maximum of $50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect.

If, however, the failure to file is due to intentional disregard of the filing requirements, the penalty is not less than 10 percent of the aggregate amount not properly reported and the $50,000 limitation will not apply. In the case of an information return required to be filed by a broker under section 6045, the penalty is not less than 5 percent of gross proceeds required to be reported, without regard to the $50,000 limitation.

Also, a person required to file an information return generally must furnish a written information statement to the person to whom the payment was made showing certain information. For example, written statements must be furnished to recipients of payments that are reported under section 6041(a) (information at source), section 6041A (remuneration for services), section 6042(c) (payments of dividends), section 6045 (return by brokers), and section 6049(a)(1) (payment of interest aggregating $10 or more). Failure to furnish such statements to payees as required subjects the payor to a penalty of $50 for each failure, up to a maximum penalty of $50,000 for any calendar year. This penalty is not applicable if the payor's failure is due to reasonable cause and not to willful neglect.

Information returns must generally show the name, address and taxpayer identification number (TIN) of the payor and payee. If any person (1) required by regulation to include his TIN in any return, statement, or other document, (2) to furnish his TIN to another person, or (3) to include in any return, statement, or other document made with respect to another person the TIN of such other person, fails to do so at the time prescribed, such person is liable for a penalty of $50 ($5 in case (1)) for each failure up to $50,000 in any calendar year. The penalty does not apply if the failure is due to reasonable cause.

Failure to comply with the Bank Secrecy Act reporting requirements can result in criminal sanctions. Fines of up to $500,000 and

imprisonment for up to five years are provided for long-term patterns of significant violations, and violations in furtherance of certain other Federal crimes. It is also a felony to make a false or fraudulent statement in any of the required reports. Currency and monetary instruments can be seized if they are not reported, or if the report omits material facts. Additional civil penalties are also provided.

F. Penalty Provisions Relating to Third Parties

1. Promoting abusive tax shelters

Any person who organizes, assists in the organization of, or participates in the sale of any interest in a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement and who makes or furnishes (in connection with such organization or sale), (1) a statement with respect to the allowability of any tax benefit by reason of participating in the entity, plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, or (2) a gross valuation overstatement with respect to any matter material to the entity, plan or arrangement, whether or not the accuracy of the statement of valuation is disclaimed, is subject to a civil penalty. Thus, persons subject to the penalty may include not only the promoter of a tax shelter partnership but also any other person who organizes or sells a plan or arrangement with respect to which there are material misrepresentations or valuation errors affecting the tax benefits to be derived from participation in the arrangement.

A matter is material to the arrangement if it would have a substantial impact on the decision making process of a reasonably prudent investor. A gross valuation overstatement is any statement or representation of the value of services or property which exceeds 200 percent of the correct value of the property or services and which is directly related to the amount of any income tax deduction or credit allowable to any participant.

The penalty for promoting an abusive tax shelter is an assessable penalty equal to the greater of $1,000 or 10 percent of the gross income derived, or to be derived, from the activity. There need not be reliance by the purchasing taxpayer or actual underreporting of tax.

The Secretary is given authority to waive all or part of any penalty resulting from a gross valuation overstatement, upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith.

2. Understatement of tax liability by income tax return preparer

An income tax preparer is subject to certain penalities for the negligent or willful understatement of a client's tax. An income tax return preparer is subject to a $100 penalty for each return or claim on which an understatement of tax liability results from the tax preparer's negligent or intentional disregard of rulings or regulations. A $500 penalty applies in the case of each return or claim on which an understatement of tax liability results from the tax return preparer's willful attempt to understate his client's tax liability. If an understatement results from both the negligent and willful actions of a tax return preparer, both the negligence and

willful understatement penalties apply and the amount of the willful understatement penalty is reduced by an amount equal to the negligence penalty.

The negligent and willful understatement penalities are both assessable penalties. However, certain procedural rules apply which allow a tax return preparer against whom either penalty is imposed an opportunity for district court review of the Secretary's notice and demand for the penalty on payment of 15 percent of the amount claimed, the filing of a claim for refund, and pursuit of the claim in the district court. If there is, at any time, a final administrative determination or final judicial decision that imposition of the penalty was incorrect, the penalty will be abated and any amounts paid refunded.

3. Aiding and abetting the understatement of tax liability

Any person who aids, assists in, procures, or advises the preparation or presentation of any portion of a return, affidavit, claim or other document under the internal revenue laws which the person knows will be used in connection with any material matter arising under the tax laws, and which portion the person knows will (if used) result in an understatement of the tax liability of another person, is subject to a penalty.

The penalty applies as a civil counterpart to the criminal penalty on aiding or assisting in the preparation or presentation of false or fraudulent statements, returns or other documents. The penalty does not apply to persons who aid or assist with respect to any preparation or presentation of documents in a manner that is merely negligent.

No person is subject to the penalty unless that person is directly involved in aiding or assisting in the preparation or presentation of a false or fraudulent document that will be used under the tax laws, or "procures" a subordinate to do any act punishable under this provision. The penalty does not apply to any person who merely furnishes typing, reproducing or other mechanical assistance in the preparation of the return, etc.

The term "procures" includes ordering or otherwise causing a subordinate to do an act subject to this penalty, or knowing of and not attempting to prevent participation of a subordinate in an act subject to this penalty. Thus, the penalty imposes an affirmative duty on supervisors to act to prevent the conduct proscribed by the provision when he knows it is occurring. The term "advises" includes acts of independent contractors such as attorneys and accountants in counseling a particular course of action. A "subordinate" is any individual, including an agent, over which the person has direction, supervision, or control. Direction, supervision, or control for this purpose includes only direct and immediate direction, supervision, and control.

This penalty, which is $1,000 for each return or other document ($10,000 in the case of returns and documents relating to the tax of a corporation), can be imposed whether or not the taxpayer knows of the understatements. The penalty can, however, be imposed only once for any taxable period (or taxable event) with respect to documents relating to any one person.

G. Standards for Imposition of Penalties

Under present law, taxpayers may be subject to various additions to tax or civil penalties for failure to comply with filing or payment requirements of the internal revenue laws. With the exception of the addition to tax for failure to pay estimated income tax or for overvaluations, or for substantial understatements, additions and penalties are generally subject to the taxpayer's defense of "reasonable cause," or the Government is required to prove negligence, fraud, or that the noncompliance was willful.

1. Strict liability

The addition to tax for failure to pay estimated tax and the two overvaluation penalties are assessed on a strict liability standard. The Secretary may waive the addition to tax for overvaluations in the case of good faith errors if the taxpayer had a reasonable basis for the valuation claimed. A standard similar to strict liability applies under the substantial understatement penalty in the absence of substantial authority or disclosure or, in the case of tax shelters, the taxpayer's reasonable belief that he was more likely than not to prevail.

2. Reasonable cause

Whether a taxpayer's noncompliance is "due to reasonable cause and not due to willful neglect" depends on the facts and circumstances of each case. For example, for purposes of the addition to tax for failure to file a return or pay tax, if a taxpayer has an honest belief that he need not file a return or pay an amount of tax, his failure to file or pay may be due to reasonable cause and not willful neglect. On the other hand, ignorance of the law requiring such filing has generally not been viewed by the courts as reasonable cause for failing to comply with filing requirements. Although a taxpayer's uninformed and unsupported belief that he need not file or pay tax is not reasonable cause, a taxpayer's limited education and business experience, together with reliance on the advice of an attorney or certified public accountant, has been held to be reasonable cause for a failure to file a return.

Also, a taxpayer's failure to file has been found due to reasonable cause when the taxpayer was mentally incompetent, or when illness prevented the taxpayer from obtaining the necessary records for filing. A taxpayer's incarceration or lack of funds does not, however, constitute reasonable cause.

3. Negligence and civil fraud

If any part of an underpayment of tax is due to "negligence or intentional disregard of rules and regulations (but without intent to defraud)" an addition to tax equal to 5 percent of the entire underpayment may be imposed. In addition, an amount equal to one-

half the interest due on the underpayment attributable to negligence will be added to the tax. Similarly, if any part of an underpayment is due to fraud an addition to tax equal to 50 percent of the entire underpayment may be imposed together with an amount equal to one-half the interest due on the underpayment attributable to fraud.

Whether the taxpayer has been negligent is a question of fact. Ordinarily, the negligence addition to tax will not be imposed where a taxpayer relied on his attorney or certified public accountant and such agent erred in the preparation of the taxpayer's return. But the taxpayer may be found negligent if he carefully reviewed his return and should have noticed the error, or if he failed to supply his agent with complete information for the return.

Also, if a taxpayer intentionally disregards rules and regulations, he or she may be considered negligent. Likewise the taxpayer's own conviction that the relevant rules or regulations misinterpret the law in a certain instance, if used as a reason for his subsequent disregard thereof, will not necessarily prevent the negligence penalty from being imposed. Generally, the Internal Revenue Service has ruled that when an error is made due to an honest misunderstanding of the facts or the law, the addition for negligence should not be asserted.

For the fraud addition to tax to apply it is necessary to show that there was fraudulent intent to evade tax and an underpayment of tax. Mere negligence, or ignorance of the law, does not constitute fraud. Generally, a corporation is responsible for the fraudulent acts of its officers committed on its behalf, and an individual taxpayer cannot escape the penalty for fraud by delegating the preparation of his return to another. Although, ordinarily, a taxpayer will not be held liable for the fraud addition to tax if he acts upon advice of counsel, he must show that he gave complete and accurate information to his attorney, that he relied on the attorney's advice, and did not have knowledge that the advice of the attorney was incorrect. Finally, a voluntary disclosure after the fact (for example, by the filing of an amended return) will not necessarily relieve a taxpayer of the civil fraud penalty, nor of criminal prosecution therefor.

4. Willful noncompliance

Willful noncompliance with the internal revenue laws is a fact question. Although "willfulness" is most often associated with criminal penalties, it can also arise in the civil penalty area.

The concept of willfulness is exemplified by its use in the section 6672 penalty for failure to collect, account for, and pay over taxes. The standard of willfulness applied by the courts under that section does not require any bad motive or evil intent on the part of the responsible party. Rather, an intent to do the proscribed act itself is sufficient to render the act "willful." For example, if it is shown that an employer knowingly and intentionally used withheld payroll taxes to pay operating expenses or other debts of the business the act will be deemed willful for purposes of this penalty. Most courts reject the contention that reasonable cause or justifiable excuse plays a part in determining whether the responsible party's actions are willful.

H. Injunctive Authority

In addition to its general authority to seek appropriate remedies in the courts of the United States, the Justice Department is specifically authorized to seek injunctions against income tax return preparers who engage in certain prescribed conduct or otherwise engaged in fraudulent or deceptive conduct. Income tax return preparers may, in certain circumstances, post a bond to avoid such injunctions. The Justice Department is also authorized to seek injunctions against fraudulent tax-shelter promoters to prevent further fraudulent activity.

I. Interest on Underpayments or Overpayments of Tax

1. Underpayments

Under present law, if a tax is not paid on or before the last date prescribed for payment, interest must be paid by the taxpayer on the unpaid amount for the period from the last date prescribed for payment to the date of payment at an annual rate established under section 6621.

In general, the last date prescribed for payment is the due date of the return determined without regard to any extension of time for payment and without regard to any notice and demand for payment issued by reason of a jeopardy assessment (but not later than the date notice and demand for the tax is made by the Secretary). Certain taxes, other than the income tax, may be paid in installments. If an election to pay such taxes in installments is made, the date prescribed for payment of each installment of tax is generally the date from which interest runs.

If the amount of any underpayment of income tax is reduced by reason of a net operating, or net capital, loss carryback, such reduction does not effect the computation of the interest payable on such underpayment prior to the due date (without extensions) of the income tax return for the loss year. Similar rules apply with respect to credit carrybacks.

2. Overpayments

Under present law, interest is paid by the United States on the overpayment of any tax at the annual rate established under section 6621. Generally, interest is paid with respect to a credit from the date of overpayment (generally the due date of the return) to the due date of the amount against which the credit is taken. In the case of a refund, interest is generally paid from the date of overpayment to the date (to be determined by the Secretary) preceding the date of the refund check by not more than 30 days. However, if the credit or refund is claimed in a late return, no interest is allowed or paid for the period before the date the return is filed. No interest is allowed on an overpayment of income tax if such overpayment is refunded within 45 days after the last date prescribed for filing the return of such tax (without regard to any filing extensions) or, if later, within 45 days after the date the return is filed. Finally, no interest is allowed unless the return is in processable form.

An overpayment resulting from a net operating loss carryback, a net capital loss carryback, or credit carryback is treated as occurring on the due date (without extensions) of the return for the year in which the carryback arises. In the case of a refund, the return for the loss year is treated as not filed prior to the time the claim for refund therefore is filed. Therefore, no interest would be paid

on a refund claimed on a late return if the refund is made within 45 days after the return is filed. For purposes of the payment of interest on overpayments, a return is not treated as filed until filed in processible form.

3. Rate of interest

Both the taxpayer and the United States must pay interest compounded at the annual rate established under section 6621. Under present law interest rates are redetermined twice a year on the basis of the average adjusted prime rate charged by commercial banks during the six-month period ending September 30 (effective January 1 of the succeeding calendar year), and March 31 (effective July 1 of the same calendar year).

II. IRS ADMINISTRATIVE EFFORTS TO IMPROVE TAXPAYER COMPLIANCE

A. Taxpayer Services Provided by the Internal Revenue Service

1. Programs under the Associate Commissioner (Data Processing)

In general

The IRS conducts a year-round tax information program in each of its 7 regions, 60 internal revenue districts, 10 internal revenue service centers, and in various foreign countries (though the Foreign Operations District (FOD). The basic assistance part of the program is operated by the Associate Commissioner (Data Processing) through the Assistant Commissioner (Returns and Information Processing). Assistance ranges from interpreting technical provisions of the tax law to answering questions on tax account status and furnishing forms requested by taxpayers. In addition, since 1977, the Service has operated a special Problem Resolution Program (discussed below) to handle situations in which normal procedures are considered inadequate.

Taxpayer assistance is provided by three principal methods: telephone assistance, assistance to taxpayers who walk into an Internal Revenue Service office, and taxpayer information and education programs, including programs directed at special groups.

Telephone assistance

A toll-free telephone network allows taxpayers to call IRS personnel for tax assistance. This service covers all of the United States, Puerto Rico, and the Virgin Islands. In addition, assistance is provided without cost to deaf and hearing-impaired taxpayers through a television/telephone/teletypewriter system.

Walk-in taxpayer assistance

The walk-in taxpayer assistance program is available both at permanent and temporary (during the filing season) sites located throughout the country. This is basically a self-help program which includes answering taxpayers' questions and furnishing tax forms and publications. The IRS does not provide direct return preparation assistance on a general basis.

Taxpayer information and education

In addition to its telephone and walk-in assistance programs, the IRS presently conducts a year-round public information program with special emphasis on the filing period (January through April). This program includes training participants in several volunteer programs and supervising the programs, directing educational programs for taxpayers, and preparing media efforts for targeted groups and the general public.

The Volunteer Income Tax Assistance Program (VITA), begun in 1969, provides assistance in completing tax returns to low-income, elderly, and non-English speaking persons who would have difficulty obtaining assistance from paid tax return preparers or IRS walk-in assistance personnel. Community volunteers are trained by the IRS in simple tax return preparation skills. These individuals then offer free tax return preparation assistance in neighborhood locations throughout the country.

Tax Counseling for the Elderly, a similar volunteer program, was established by the Revenue Act of 1978, to help meet the special tax needs of persons aged 60 and older. Under this program, the IRS enters into agreements with selected nonprofit organizations which provide volunteers to furnish tax assistance to the elderly. The volunteers are reimbursed by the IRS, through the sponsoring organizations, for out-of-pocket expenses incurred in providing the assistance.

The Student Tax Clinic Program is conducted at 13 colleges and universities across the country. Under this program, law and graduate accounting students represent low-income taxpayers before the IRS in examination and appeal proceedings.

Small Business Workshops and Tax Practitioner Institutes are conducted in each internal revenue district to educate small businessmen and tax practitioners on recent tax developments which may affect them.

Disaster and Emergency Assistance Programs are conducted by IRS in cooperation with other government agencies to provide specialized tax information to victims of major disasters and emergencies.

The Understanding Taxes and Fundamentals of Tax Preparation Programs provide free student publications to high schools and colleges. Additionally, under this program, IRS employees may meet with teachers to explain these publications and answer questions on tax laws and procedures.

2. Problem Resolution Program and Office of the Taxpayer Ombudsman

In 1977, the Internal Revenue Service implemented a taxpayer complaint response system, known as the Problem Resolution Program (PRP), in each of its districts. Under this program, there is a Problem Resolution Officer in each district who reports directly to the district director. In 1979, this program was expanded to cover all Internal Revenue Service centers, as well as districts.

PRP was established to handle taxpayers' problems and complaints not promptly or properly resolved through normal procedures, or those problems which taxpayers believe have not received appropriate attention. In addition, the program provides for the analysis of problems resolved by it to determine their underlying causes so corrective action can be taken to prevent their recurrence.

In 1979, the IRS established a Taxpayer Ombudsman in the Office of the Commissioner of Internal Revenue. The responsibilities of the Ombudsman include the administration of the Problem Resolution Program; representation of taxpayer interests and concerns within the IRS decisionmaking process; review of IRS policies

and procedures for possible adverse effects on taxpayers; proposal of ideas on tax administration that will benefit taxpayers; and representation of taxpayer views in the design of tax forms and instructions.

In 1982, 256,496 individual taxpayer problems were resolved by the Problem Resolution Program.

B. Internal Revenue Service Collection and Enforcement Efforts

The major function of the IRS is to collect revenue and enforce the tax laws. The enforcement efforts complement IRS collection efforts both by assisting directly in those collection efforts and by encouraging voluntary compliance with the tax laws.

The following is a summary of the major IRS collection and enforcement efforts in fiscal year 1982.[1]

1. Collection efforts

Returns received

During 1982, the IRS received and processed 170.4 million returns and supplemental documents. Of these, 95.5 million (56.0 percent) were individual income tax returns.

Tax receipts

Gross tax receipts in fiscal year 1982 were $632.2 billion. Income taxes accounted for more than two-thirds of this amount. Individual income tax receipts were $352.6 billion and corporation income tax receipts were $66.0 billion.

Social security, self-employment, Federal unemployment, and railroad retirement taxes accounted for $168.7 billion. In addition, excise tax revenue was $36.7 billion. Finally, receipts from estate and gift taxes were $8.1 billion.

Refunds

In 1982, the IRS paid $75.2 billion in refunds to 74.5 million taxpayers. Of this amount, $55.1 billion went to filers of Forms 1040 and 1040A.

Penalties

During 1982, the IRS assessed 26.3 million civil penalties, amounting to about $5.1 billion (about $100 million in penalties was abated). These penalties were assessed primarily for failure to pay tax, pay estimated tax, late filing, and negligence and fraud.

Combined annual wage reporting

Combined annual wage reporting is a system that is designed to reduce the reporting burden for employers while still satisfying the reporting requirements of both the IRS and the Social Security Administration.

In January 1980, the IRS began a program to ensure that amounts reported on employment tax returns filed with the IRS agree with Forms W-2 filed with the Social Security Administra-

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[1] The information in this section was derived from the 1982 Annual Report of the Commissioner of Internal Revenue.

tion. This reconciliation is designed to assure that the correct wages have been reported and that employees have received the correct social security coverage. As a result of this program, $218.1 million in additional tax was assessed in 1982.

2. Enforcement efforts

Examination and correction results

The IRS examined 1,732,232 returns in 1982. Examination coverage of income, estate, and gift tax returns was 1.63 percent.

The IRS examination program resulted in recommendations for additional tax and penalties of $11.7 billion. Of that amount, individual and fiduciary income tax returns accounted for $3 billion, corporate income tax returns for $7.2 billion, estate and gift returns for $0.8 billion, and employment and excise returns for $0.2 billion. This program also disclosed overassessments on 114,602 returns, resulting in refunds of $0.5 billion.

In addition to the IRS examination program, 716,193 returns were verified or corrected through correspondence from IRS service centers. This type of examination resulted in recommended additional tax and penalties of $268 million.

Information returns program

The Internal Revenue Service received 664 million information documents in its tax year 1981 information returns program includin over 178 million Forms W-2 processed by the Social Security Administration and 50 million pre-1974 Series E savings bonds from the Bureau of Public Debt. There were also 435 million information returns received from businesses and organizations reporting interest dividends and other payments. More than 354 million of these documents were submitted on magnetic media. The Internal Revenue Service matches almost all of the information returns submitted on magnetic media to verify that correct amounts are reported on taxpayers' returns. About 21 percent of the information returns submitted on paper are processed, and 82 percent of the combined magnetic media and paper receipts are processed. In 1981, the Internal Revenue Service began associating information returns with cases of taxpayers who filed income tax returns in previous years but failed to do so for the current year.

As a result of its information returns program, the Internal Revenue Service notified over 2.9 million taxpayers in 1982 of potential discrepancies between income reported on their tax returns and income reported on information returns. Furthermore, 2.1 million taxpayers were sent notices of apparent failure to file tax returns based on information returns.

Windfall profit tax

In 1982, the IRS completed examination of more than 507 windfall profit tax returns. Windfall profit tax liabilities reported on returns processed through September 30, 1982, amounted to about $2.2 billion.

In the 1982 examination program for the windfall profit tax, over 500 examinations, resulting in $0.5 billion in recommended additional tax and penalties were completed.

Coordinated examination program

The coordinated examination program (CEP) includes the largest taxpayers in the country. There are 9 criteria (including assets, receipts and operating entities) which are used to identify a CEP taxpayer. The CEP is a two-tiered program involving a National and Regional CEP. The most complicated cases are assigned to the National program.

At the end of fiscal year 1982, there were 1,438 large corporation cases in the CEP. Recommended tax deficiencies and penalties for the 12-month period ending September 30, 1982 were $5.77 billion.

Tax shelters

As of September 30, 1982, there were 284,828 returns with tax shelter issues in the examination process. During 1982, 71,793 returns were closed with recommended tax and penalties of $954.2 million.

In 1981, the IRS established special examination groups for commodity shelters.

W–4 program (withholding allowance certificates)

The W–4 program was established in 1980 to check abuses by employees who file incorrect withholding allowance certificates with employers to avoid having high income tax withheld from wages.

During 1981, the IRS expanded the monitoring of employer compliance with the withholding requirements. Furthermore, the IRS has developed a computer system to detect employers who have not submitted required Forms W–4 to the IRS. In addition, a program has been established to follow up automatically on W–4 filers who failed to file 1980 tax returns.

Unreported income program

The IRS currently is working to develop the capability to identify potential unreported income on filed returns through its discriminant function (DIF) scoring system.

International enforcement

Examinations of business operations outside the U.S. are handled by approximately 290 international examiners located in 15 key districts. In 1982, these examiners participated in the examination of 2,976 returns and recommended adjustments and penalties of $3.7 billion.

The Foreign Operations District (FOD) has jurisdiction to audit foreign based taxpayers with books and records in another country who are subject to U.S. income tax. It has foreign posts located in 16 key cities around the world. These foreign posts are headed by revenue service representatives who manage the examination, collection, and taxpayer service programs at those posts. In addition, FOD and its overseas representatives are responsible for the exchange of information with U.S. treaty partners, and for other overseas tax information gathering. In 1982, FOD examined over 18,000 returns and recommended additional tax and penalty assessments of about $160 million.

Criminal investigation

The general enforcement program of the Criminal Investigation Division of the IRS (CID) identifies income tax evasion cases with prosecution potential. The program also attempts to provide balanced criminal tax enforcement and geographical and occupational coverage of various types of alleged tax law violations. During 1982, priority enforcement efforts included investigating individuals who filed multiple claims for tax refunds, illegal tax protesters, and promoters of fraudulent tax shelters.

The special enforcement program of the CID identifies and investigates individuals who derive substantial income from illegal activities and violate the tax laws. The program also includes such projects as the Federal strike force program against organized crime, the high-level drug dealers project, wagering tax enforcement, and other efforts against racketeers. CID initiated 6,498 investigations in 1982 and completed 5,831 investigations. Prosecution was recommended in 2,297 of the completed investigations.

Cooperation with other agencies

The IRS is involved in the Federal strike force program against organized crime. The Department of Justice coordinates investigations in 15 strike forces located in 25 cities. The CID also participates in financial investigative task forces established by U.S. attorneys to coordinate the various Federal law enforcement agencies' efforts against major narcotics organizations. Furthermore, IRS special agents are detailed to the drug enforcement administration to identify narcotics traffickers subject to the internal revenue laws.

Narcotics traffickers

Since 1980, the IRS has more than doubled the number of staff years involved in investigations of high-level drug traffickers, financiers, and money launderers in its special enforcement program. As of September 30, 1982, there were 807 such cases under investigation and another 262 undergoing IRS and Department of Justice review before indictment.

Tax protesters program

The IRS had 30,956 protest returns under examination and had closed 10,378 returns as of September 30, 1982. This was a 12.1 percent increase over 1981.

Collection of delinquent accounts

During 1982, the IRS disposed of 2.4 million delinquent accounts and collected $7.4 billion in overdue taxes. Of that amount, $3.1 billion was collected in response to computer notices sent to taxpayers and $4 billion was collected on delinquent accounts. In addition, $331 million were collected when 1.7 million delinquent returns, involving $2.4 billion in additional assessments, were secured.

IRS service center collection branches handle computer delinquency notices. This is the first step in communication with taxpayers who have not filed returns or paid taxes. The service centers also perform such procedures as associating taxpayer corre-

spondence, screening cases to determine that a final notice has been sent. In addition, many procedures that were previously performed in the districts have been absorbed by the service center collection branches, including the monitoring of employers' monthly tax returns, insolvency case processing and the control, maintenance and monitoring of 100-percent penalty cases.

If taxpayers do not resolve delinquent accounts or delinquent return investigations in response to notices from service centers, their cases are transferred to district offices. Most of these transferred cases are worked first by clerical and paraprofessional employees in the collection office function. However, the more difficult delinquent accounts and return investigations are referred to the collection field function to be handled by revenue officers.

Nonfilers and delinquent returns

The Internal Revenue Service has special programs to deal with the problems of nonfilers and delinquent return filers. New procedures for early identification and contact of income tax nonfilers were established in 1980 and further refined in 1981. In addition, in 1981, changes were made in the delinquent returns programs to place greater emphasis on matching information documents and tax returns.

In 1982, the IRS began a research project to determine whether revenue yield can be increased if the accounts of identifiable groups of taxpayers are handled differently. A total of 50,000 individual income delinquent accounts are being handled in six different ways. The IRS also conducted approximately 22,000 taxpayer compliance measurement program investigations of potential nonfilers of tax year 1979 income tax returns.

III. POSSIBLE APPROACHES TO IMPROVING TAX COMPLIANCE

This part discusses a broad range of approaches to improving taxpayer compliance which could be considered by the Congress. Many of these approaches are the product of work done not only by the tax-writing committees but also by the American Bar Association, the American Institute of Certified Public Accountants, the New York State Bar Association, the Department of the Treasury, the U.S. General Accounting Office, and the Department of Revenue of the State of Minnesota. In particular, attention is called to the report of the *Invitational Conference on Income Tax Compliance,* prepared by the Section of Taxation of the American Bar Association; *Comments on the Tax Compliance Act of 1982,* New York State Bar Association, Tax Section, Committee on Unreported Income; and *Unreported Taxable Income: The Problem and Possible Solutions,* by the Federal Tax Division of the American Institute of Certified Public Accountants.

The precise reasons for the decline in voluntary compliance cannot be easily identified. However, a number of factors may contribute to the problem. For example, the complexity of the tax code and frequent changes in its provisions may contribute to higher levels of taxpayer misunderstanding than existed in earlier times. This higher level of misunderstanding would lead to an increase in inadvertent noncompliance. Noncompliance may be due to inadequacies in the information reporting and withholding systems. If a taxpayer is not informed of items which should be included on his tax return or if incorrect amounts are reported, both the Internal Revenue Service and the taxpayer may have difficulty determining the proper treatment of that item. In addition, the Internal Revenue Service is less able to detect noncompliance in the case of an inaccurately reported item. Further, if the penalties provided under present law are insubstantial in amount or uncertain in their applications taxpayers may consider the cost of noncompliance as relatively low. Similarly, the number of times the Internal Revenue Service contacts taxpayers and the number of returns selected for audit may directly affect the public perception of the risks associated with noncompliance. The growth in international business, and the increased sophistication of taxpayers also opens new opportunities for noncompliance. A number of approaches could lead to increased voluntary compliance either through better understanding of the internal revenue laws or through increasing the risks associated with noncompliance.

Education

To comply with the internal revenue laws, taxpayers must have a general awareness of the requirements imposed on them and an ability to obtain accurate information when they seek to comply

with these requirements. For example, many believe that the frequent failure of taxpayers to pay estimated tax is the result of a relatively low level of awareness with respect to the estimated tax payment requirements. Similarly, a significant number of the individuals who fail to file the required income tax returns are subject to wage withholding and may incorrectly believe that payment of tax through the withholding system relieves them of the obligation to file an annual return. It has been suggested that the relatively low level of compliance with respect to pension payments may result from the belief by many taxpayers that retirement income is not subject to Federal income taxation. A broad-based program of public education or an increase in the Internal Revenue Service's taxpayer assistance program might have a positive effect in reducing noncompliance in these and similar areas. There are, however, no data which suggest whether such an educational program would be more or less effective in reducing noncompliance than greater information reporting requirements, broader withholding requirements, or increased sanctions for failure to comply.

Simplification

The complexity of the tax laws and the frequency with which they are modified may adversely affect the ability and willingness of taxpayers to comply with the requirements of those laws. For example, a taxpayer who believes that the required returns cannot be understood or filed properly may be less likely to file a return than one who fully understands the requirements. Similarly, because of the law's complexity a taxpayer may have the impression that the law does not equitably distribute the tax burden, which may contribute to a reduction in the voluntary self-assessment. In addition, complexity may place added burdens on the Internal Revenue Service and reduce the likelihood that any particular item will be examined.

Similarly, certain deductions and credits present special challenges to a system of tax administration which audits only a small percentage of all returns. For example, under prior law, approximately one-third of all casualty loss deductions claimed were improper. Substantial examination resources of the Internal Revenue Service are allocated to insuring compliance with limitations on travel and entertainment expenditure deductions. Provisions that require records and computations based on multiple years, such as income averaging and carryovers of losses or unused credits, require extensive use of the data processing capacities of the Internal Revenue Service.

Others argue that reducing the number of taxpayers claiming itemized deducations could be reduced more simply by increasing the zero bracket amount. Any such change, however, could result in substantial revenue loss which would not be offset by increased receipts from improved compliance. Proponents of tax simplification or broad-based, low rate tax systems argue that greater compliance can be achieved by reducing the complexity of the tax laws. On the other hand, such simplification may entail substantive tax changes which may not be perceived by many as desirable. Additionally, the change to a substantially different system could result

in temporarily lower compliance rates as taxpayers adjust to the new rules.

Information reporting

The information reporting requirements of the Code are intended to serve two purposes. First, they remind taxpayers of their obligation to report amounts on their tax returns and provide them with the information needed to report the amounts. Second, they provide the Internal Revenue Service with the information necessary to detect noncompliance. The information reporting system can fail to accomplish these results in several circumstances. For example, if information returns are not filed or are filed in an incomplete or unprocessable form, their value in detecting noncompliance is lost or substantially diminished. Similarly, if the Internal Revenue Service does not have sufficient resources to pursue all detected non-compliance the value of the reporting system is eroded. In addition, if information reports are available on only some of the elements of a taxpayer's income, then the Internal Revenue Service will have greater difficulty detecting noncompliance since its information will be incomplete. Thus, if a taxpayer has income of $10,000 but processable reports are filed on only $5,000, the Internal Revenue Service will not readily detect any underreporting while processing the return as long as at least $5,000 is reported, unless matching is done on an item-by-item basis. As the information reporting system is expanded and made more accurate, this problem becomes less serious.

The quality of information reporting can be improved by requiring more returns to be in machine processable form, by increasing the penalties for failure to report or failure to provide accurate and complete reports (including removing limitations on the penalties) and by expanding the number and variety of transactions subject to such reporting.

An expansion of information reporting could take one or more directions. For example, the broker reporting regulations could require reporting of a broader range of income-related items such as gross proceeds on sales of antiques and collectibles. Amounts of tip income (both in the food and beverage industry and in other industries) that are not now subject to reporting could be brought into the system. For example, tips in excess of 8 percent in establishments with high tip rates (e.g., establishments with high charge tip rates) could be subjected to information reporting. Expansion of information reporting to deduction items or to further income-related items might be criticized as imposing disproportionate burdens in small businesses.

Another approach would be to require information reporting designed to enable the Internal Revenue Service to cross-check deductions or credits claimed by taxpayers. This type of reporting requirement could be criticized as shifting costs which should be borne by the Internal Revenue Service audit function to the private sector. In addition, to be effective, some reporting of this type might require taxpayers to provide greater detailed information on tax returns. This could be viewed as an inappropriate increase in paperwork burdens on the private sector. Finally, many individual taxpayers do not itemize their deductions; therefore, reporting on

deduction items could entail reporting of many transactions which are of little interest to the Internal Revenue Service.

A third approach would be to require reporting of information designed to assist the Internal Revenue Service in identifying nonfilers and underreporters. For example, a number of States have used information on professional licensing and on large purchases (e.g. luxury cars) to identify nonfilers. Several bar and accounting professional groups have suggested reporting of large cash purchases. This might enable the Internal Revenue Service to identify taxpayers with unreported cash income. On the other hand, such reports might impose substantial burdens on small business taxpayers and may be questioned as imposing too high a cost relative to the benefits to be derived in tax collections.

A fourth approach would be to impose stricter standards on the format in which information is reported to the Internal Revenue Service. Increased use of magnetic media and other machine readable formats might improve the usefulness of the information reported. Information reporting format requirements might impose new costs on reporting taxpayers. Simplifying returns, where appropriate, could also increase the quality of information reporting.

Detection of noncompliance can also be improved through strengthening the ability of the Internal Revenue Service to obtain relevant information. For example, tax treaties could provide for increased information exchanges between taxing authorities and enlarged U.S. access to records held by third parties overseas.

With respect to any of these possible expansions of information reporting, it is not clear that the current data processing capacity of the Internal Revenue Service can effectively absorb the increased input. Further, many of the potential deficiencies detected by the present information reporting system are not pursued because of resource constraints. Imposing information reporting costs on the private sector would be difficult to justify if the Internal Revenue Service could make only limited use of the information.

Withholding

The most recent Internal Revenue Service compliance data indicates that 99 percent of all wages subject to withholding are reported on tax returns. This high compliance rate is generally attributed to the fact that tax is withheld before the taxpayer receives payments, to the high degree of accuracy in information reported with respect to withheld amounts, and to the ability of the Internal Revenue Service to detect noncompliance effectively. In addition, persons entitled to credits or refunds arising from wage withholding have a strong incentive to file returns and claim those credits or refunds. Although withholding appears to result in higher compliance rates, some people may question whether withholding requirements should be expanded, without first requiring the Internal Revenue Service to make full use of the information reporting system. An expansion of the backup withholding system of present law may offer a means of targeting withholding to noncompliant taxpayers.

Recordkeeping

Taxpayers are currently required to maintain books and records. Failure to maintain such books and records leads to penalties only in the case that the taxpayer has underpaid his tax. The current recordkeeping requirements could be expanded by requiring certain large business taxpayers to have their tax returns or financial statements prepared by third parties or otherwise audited. The recordkeeping requirements could also be expanded to require syndicators of tax-oriented investments to maintain records identifing their investors. Such requirements, however, may unnecessarily add to the cost for and burden on honest taxpayers. A penalty might be imposed for a failure to maintain and present minimal records regardless of whether any tax were owed.

Tax professionals and other third parties

Present law imposes certain responsibilities on income tax return preparers and other tax professionals. These responsibilities (other than for tax return preparers) were substanially increased in 1982. The General Accounting Office issued a report cite critical of the Internal Revenue Service implementation of the income tax return preparer system. In general, the tax return preparer regulatory system has not been reviewed since it was created in 1976. Further review of the tax return preparer system and other professionals may reveal legislative changes which may lead such professionals to play a more constructive role in improving taxpayer compliance. Some have even suggested the creation of a private auditing system to complement auditing by the Internal Revenue Service.

In addition, some insurance companies are now prepared to offer insurance against the risk that if a return is audited, the Internal Revenue Service will require the payment of additional taxes, interest, and perhaps even penalties. Such insurance may be viewed by some as contrary to sound public policy in that it encourages taxpayers to understate their tax liability without bearing the full risk of that decision.

Increased Internal Revenue Service enforcement efforts

The ultimate deterrents to noncompliance are Internal Revenue Service enforcement efforts and the penalties and interest changes imposed on taxpayers who fail to comply. Thus, an increase in compliance could be expected from increased spending on Internal Revenue Service enforcement activities. For example, the Internal Revenue Service audits only a very small percentage of all filed returns. Moreover, the percentage of returns examined has declined substantially in recent years because of reductions in the IRS budget. There are many more returns which could be expected to require adjustments if audits were conducted. Similarly, a significant percentage of the discrepancies and non-filings detected by the information returns program are not pursued because of resource constraints on the Internal Revenue Service. Finally, even when tax deficiencies are determined to exist, the resources are not available to take collection action with respect to many of these delinquent accounts. Suggestions to address the Internal Revenue Service's resource constraints have included (1) modest funding in-

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creases of the sort enacted for fiscal year 1983, (2) large increases in particular functions and (3) treating Internal Revenue Service spending as an offsetting entry relative to tax receipts which would, in effect, place Internal Revenue Service spending outside the unified budget.

Another approach to encouraging compliance would be to increase the interest charged on tax deficiencies based on the view that most individuals borrow at higher interest rates than the rate of interest now charged by the Internal Revenue Service. Increasing the current interest rate, however, could create an incentive for taxpayers to overpay their income tax liability and thereby invest at a rate of return above prime rate. Thus, it could be necessary to consider denying interest in some refund cases, or providing a lower rate of interest on refunds than on deficiencies.

Although the penalty structure under the Internal Revenue Code was reviewed in 1982, several suggestions for increases or expanded coverage have been made with respect to present law. For example, the Senate has adopted amendments removing the limitations on payor penalties for failure to comply with information reporting requirements in certain cases. Last year, the Senate Committee on Finance reported a penalty on substantial underpayments which would have applied unless the taxpayer reasonably believed that the position taken was more likely than not to prevail. Another suggestion has been that a no-fault penalty could apply to any failure to report certain classes of income such as gross receipts from a business or cash income. Finally, some tax-shelter promoters have characterized the promoter penalty enacted last year as an empty threat because of its perceived low level.

Reliance solely on enforcement activities, interest charges, and penalties to increase compliance could reduce voluntary compliance if taxpayers were to develop a strongly negative attitude toward the Internal Revenue Service as a result of increased intrusions by the Internal Revenue Service into their lives. Some have suggested that too heavy an emphasis on penalties could create a "catch-me-if-you-can" mentality which would erode compliance.

The Internal Revenue Service enforcement efforts could also be bolstered by providing alternatives, such as backup withholding or increased withholding on noncompliant taxpayers, to enhance collections.

Non-tax amendments

It has been suggested that tax compliance might also be improved through a variety of non-tax amendments such as an expansion of audits by outside auditors under the securities laws, elimination of large denomination currency, and extension of the currency reporting rules to other recipients of cash. Prompter notification under the currency transaction provisions and an opportunity for action by the Treasury might be provided, particularly if the currency is to be transferred into jurisdictions who do not provide adequately for exchange of information.

Federal-State cooperation

The Internal Revenue Service presently has tax information exchange agreements with forty-eight States, the District of Colum-

bia, Guam and American Samoa. These agreements assist the Internal Revenue Service and State taxing authorities in identifying persons who have failed to file Federal or State tax returns by providing for cooperative inspection of tax records.

Expanding the scope of Federal-State cooperation is a potentially effective and cost-efficient means for both the Internal Revenue Service and State taxing authorities to improve taxpayer compliance. The Internal Revenue Service and State taxing authorities face similar budgetary and practical constraints in the enforcement and collection areas. Expanded information exchange and other forms of cooperation may eliminate wasteful duplication of effort. For example, expanded information exchange could permit taxpayer data required by both Federal and State authorities to be collected only once. In addition, in some situations, the Internal Revenue Service may have readier access or the only access to data required by the States, and vice-versa. For example, Data exists outside conventional tax administration channels at both the Federal and State levels that could assist the Internal Revenue Service and the States in identifying nonfilers and underreporters. Records of such Federal agencies as the Departments of Labor and Agriculture, which contain taxpayer identification numbers could be used by both the Internal Revenue Service and the States; however, the Internal Revenue Service can more easily aggregate such Federal agency data than can the States. State licensing (for example, law practice licensing) and county property tax records, which can also be an effective tool in detecting nonfilers and underreporters, are, on the other hand, most readily available to the respective State taxing authorities. The gathering and exchange by the Internal Revenue Service and the States of such types of information could be of special benefit to the Internal Revenue Service because, under current exchange agreements, the Internal Revenue Service receives, the results of all State audits that produce increases in Federal tax liability. To encourage States to participate, "seed money" could be provided by the Federal government for specific projects or the Federal government might simply purchase important data from the States. Significant expansion of the kind of information exchange would raise privacy concerns.

With respect to the conduct of audits, a few States presently work with District Offices on various projects to coordinate and, improve their respective efforts. State and District Office participation in such projects could be expanded and different types of projects established. In other areas, the Internal Revenue Service and State departments of revenue have targeted for audit specific industries that have serious noncompliance rates and then divided the audit responsibility to avoid duplicative efforts. Other States have supplemented the Internal Revenue Service's audit program for organizers of abusive tax shelters by auditing tax shelter participants.

One State has developed a computerized levy source that the Internal Revenue Service is now sharing to improve the collectibility of delinquent accounts. Other States could be encouraged to share their levy sources with the Internal Revenue Service, particularly if the Internal Revenue Service were to share their levy sources with the States. In addition, States could be permitted to intercept Federal refunds to apply against State tax liabilities, and vice versa.

TABLES RELATED TO PROPOSAL TO CAP THE 1983 INCOME TAX RATE REDUCTION

(CONTAINED IN H.R. 1183)

SCHEDULED FOR A HEARING

by the

COMMITTEE ON FINANCE

ON JUNE 23, 1983

Prepared by the Staff
of the
Joint Committee on Taxation

June 23, 1983

JCX-15-83

Description of Tables

Table 1 shows the joint return rate schedules under present law and the Ways and Means Committee bill for calendar year 1984. This includes the tax rate in each tax bracket and the tax paid by someone whose income is at the lower end of each bracket.

Table 2 shows the levels of income above which the tax cut cap in the Ways and Means Committee bill will apply, both for non-itemizers and for itemizers whose deductions are 23 percent of income. Twenty-three percent is the average itemized deductions claimed in 1981.

Table 3A shows the tax increase from the Ways and Means Committee bill for 1984, relative to present law, for typical taxpayers with various levels of income who do not itemize their personal deductions. These numbers are shown separately for single taxpayers, one-earner couples with zero and two dependents, and two-earner couples with zero and two dependents.

Table 3B is similar to table 3A except that it assumes that taxpayers have itemized deductions equal 23 percent of income.

Tables 4A-4C show the distribution of the effects of the Ways and Means Committee bill for various income classes and types of taxpayers (e.g., single, one-earner couple, two-earner couple). Table 4A shows the number of tax returns affected; table 4B shows the average tax change per return; and table 4C shows the aggregate tax change in millions of dollars.

Tables 5A and 5B compare the tax reductions for 1984 resulting from the 1981 tax cut (net of the tax increases in the 1982 act) with the tax increases from bracket creep and legislated social security tax increases. Three alternative starting dates are used to measure inflation and social security tax increases--January 1, 1980; January 1, 1981; and October 1, 1981. (The later starting date, of course, shows a smaller tax increase from bracket creep and social security tax changes, and hence a larger net tax reduction.) Table 5B also shows what the net tax change would be after the Ways and Means Committee bill.

Table 6 shows the marriage penalty under present law and the Ways and Means Committee bill.

Table 7 shows the aggregate revenue changes for fiscal years 1984-86 resulting from legislation enacted after 1980, as well as from bracket creep and from social security tax changes enacted in 1972 and 1977. The table is limited to changes in individual income taxes, employment taxes and excise taxes. As with tables 5A and 5B, bracket creep and pre-1981 social security tax changes are measured under three alternative starting dates (with the later dates showing smaller tax increases). Also shown is the projected revenue gain from the Ways and Means Committee bill.

Table 1 - Tax Schedule under Present Law and Under the $700 Cap Proposal for 1984 (Joint Returns)

Taxable income bracket	Tax rate		Tax at beginning of bracket	
	Present law	$700 cap	Present law	$700 cap
0 to $3,400	0%	0%	$0	$0
3,400 to 5,500	11	11	0	0
5,500 to 7,600	12	12	231	232
7,600 to 11,900	14	14	483	483
11,900 to 16,000	16	16	1,085	1,085
16,000 to 20,200	18	18	1,741	1,741
20,200 to 24,600	22	22	2,497	2,497
24,600 to 29,900	25	25	3,465	3,465
29,900 to 35,200	28	28	4,790	4,790
35,200 to 45,800	33	37	6,274	6,274
45,800 to 60,000	38	42	9,772	10,196
60,000 to 85,600	42	46	15,168	16,160
85,600 to 109,400	45	50	25,920	27,936
109,400 to 162,400	49	50	36,630	39,836
162,400 and over	50	50	62,600	66,336

Table 2.--Adjusted Gross Income Levels Above Which a $700 Cap Increases Tax for 1983 and Thereafter

Filing status	Non-itemizer	Itemizer*
Unmarried individual, no dependents	$29,800	$35,714
Joint return, no dependents	$37,200	$43,896
Joint return, two dependents	$39,200	$46,494

* Itemized deductions assumed equal to 23 percent of adjusted gross income.

Table 3A - Comparison of Federal Individual Income Tax Burdens for Nonitemizers for 1984 Under Present Law and Under the $700 Cap Proposal[1]

Example #	1			2			3			4			5		
Filing status	Single			Joint			Joint			Joint Two-earner[2]			Joint Two-earner[2]		
Dependents	None			None			Two			None			Two		
Income	Tax Liability														
	present law	pro-posal	change	present law	pro-posal	change	present law	pro-posal	change	present law	pro-posal	change	present law	pro-posal	change
5000	193	193	0	0	0	0	-500	-500	0	0	0	0	-500	-500	0
10000	915	915	0	539	539	0	291	291	0	504	504	0	261	261	0
15000	1801	1801	0	1261	1261	0	959	959	0	1201	1201	0	907	907	0
20000	2945	2945	0	2101	2101	0	1741	1741	0	2011	2011	0	1661	1661	0
25000	4265	4265	0	3113	3113	0	2673	2673	0	2976	2976	0	2536	2536	0
30000	5773	5781	8	4315	4315	0	3815	3815	0	4128	4128	0	3628	3628	0
35000	7473	7681	208	5658	5658	0	5098	5098	0	5413	5413	0	4853	4853	0
40000	9369	9777	408	7198	7310	112	6538	6570	32	6868	6940	72	6218	6218	0
45000	11369	12002	633	8848	9160	312	8188	8420	232	8477	8744	267	7817	8004	187
50000	13469	14352	883	10608	11120	512	9848	10280	432	10133	10595	462	9426	9808	382
55000	15569	16702	1133	12508	13220	712	11748	12380	632	11986	12643	657	11226	11803	577
65000	20291	21663	1372	16428	17540	1112	15588	16620	1032	15746	16793	1047	14931	15898	967
75000	25091	26663	1572	20628	22140	1512	19788	21220	1432	19841	21278	1437	19001	20358	1357
85000	29935	31663	1728	24828	26740	1912	23988	25820	1832	23936	25763	1827	23096	24843	1747
95000	34935	36663	1728	29250	31636	2386	28350	30636	2286	28181	30449	2268	27281	29449	2168
100000	37435	39163	1728	31500	34136	2636	30600	33136	2536	30375	32886	2511	29475	31886	2411

1/ Computed without reference to the tax tables.
2/ Assumes 25 percent of the combined income is earned by the lesser-earning spouse.

Table 3B - Comparison of Federal Individual Income Tax Burdens for 1984 Under Present Law and Under the $700 Cap Proposal[1/]

Example	1			2			3			4			5		
Filing status	Single			Joint			Joint			Joint Two-earner[2/]			Joint Two-earner[2/]		
Dependents	None			None			Two			None			Two		
Income	Tax Liability														
	present law	pro-posal	change	present law	pro-posal	change	present law	pro-posal	change	present law	pro-posal	change	present law	pro-posal	change
5000	193	193	0	0	0	0	-500	-500	0	0	0	0	-500	-500	0
10000	915	915	0	539	539	0	291	291	0	504	504	0	261	261	0
15000	1572	1572	0	1253	1253	0	952	952	0	1193	1193	0	900	900	0
20000	2392	2392	0	1885	1885	0	1549	1549	0	1795	1795	0	1469	1469	0
25000	3348	3348	0	2596	2596	0	2218	2218	0	2466	2466	0	2106	2106	0
30000	4385	4385	0	3443	3443	0	3003	3003	0	3278	3278	0	2838	2838	0
35000	5540	5540	0	4403	4403	0	3903	3903	0	4184	4184	0	3684	3684	0
40000	6827	6959	132	5434	5434	0	4874	4874	0	5154	5154	0	4615	4615	0
45000	8210	8496	286	6555	6589	34	5952	5952	0	6197	6197	0	5637	5637	0
50000	9673	10113	440	7825	8013	188	7165	7273	108	7413	7551	138	6753	6811	58
55000	11222	11838	616	9096	9438	342	8436	8698	262	8642	8929	287	7982	8189	207
65000	14456	15457	1001	11919	12569	650	11159	11729	570	11302	11887	585	10542	11047	505
75000	17915	19188	1273	14845	15803	958	14085	14963	878	14133	15016	883	13373	14176	803
85000	21611	23038	1427	18045	19311	1266	17205	18391	1186	17153	18334	1181	16313	17414	1101
95000	25307	26888	1581	21279	22853	1574	20439	21933	1494	20282	21761	1479	19442	20841	1399
100000	27155	28813	1658	22896	24624	1728	22056	23704	1648	21846	23474	1628	21006	22554	1548
200000	65585	67313	1728	59170	62836	3666	58190	61836	3646	57700	61336	3636	56720	60336	3616
300000	104085	105813	1728	97600	101336	3736	96600	100336	3736	96100	99836	3736	95100	98836	3736
500000	181085	182813	1728	174600	178336	3736	173600	177336	3736	173100	176836	3736	172100	175836	3736
1000000	373585	375313	1728	367100	370836	3736	366100	369836	3736	365600	369336	3736	364600	368336	3736

1/ Assumes itemized deductions are 23 percent of income.
Computed without reference to the tax tables.
2/ Assumes 25 percent of the combined income is earned by the lesser-earning spouse.

Table 4A - Distributional Effects of $700 Cap Proposal Compared With 1984 Present Law by Filing Status—Returns With Tax Change

(1982 Income Levels; Number of Returns in Thousands)

Expanded Income Class 1/ ($000's)	Joint—Two-Earner		Joint—Other		Single & Head of Household		Total 2/	
	Number of returns with tax change 3/	Percent of taxable returns	Number of returns with tax change 3/	Percent of taxable returns	Number of returns with tax change 3/	Percent of taxable returns	Number of returns with tax change 3/	Percent of taxable returns
Under $10	—	—	—	—	—	—	—	—
10 - 20	—	—	—	—	—	—	12 (0.1%)	4/
20 - 30	—	—	—	—	3 (0.2%)	0.1%	141 (1.7)	0.8%
30 - 40	150 (3.8%)	2.6%	102 (3.9%)	3.5%	620 (45.8)	52.2	904 (11.2)	9.2
40 - 50	1,485 (37.9)	54.3	786 (30.0)	58.4	333 (24.6)	81.8	2,610 (32.3)	58.1
50 - 75	1,563 (39.9)	92.2	1,054 (40.3)	88.6	257 (19.0)	90.8	2,880 (35.6)	90.7
75 - 100	335 (8.6)	94.4	307 (11.7)	93.3	66 (4.9)	85.7	711 (8.8)	93.2
100 - 200	299 (7.6)	93.1	287 (11.0)	88.0	57 (4.2)	81.4	643 (8.0)	89.6
200 & over	86 (2.2)	85.1	79 (3.0)	80.6	19 (1.4)	70.4	184 (2.3)	81.1
Total	3,917 (100.0%)	17.4%	2,616 (100.0%)	13.6%	1,354 (100.0%)	3.9%	8,085 (100.0%)	10.4%

1/ Expanded income equals adjusted gross income plus excluded capital gains and various other tax preference items less investment interest to the extent of investment income.
2/ Total includes married filing separate returns that are not listed elsewhere.
3/ Percentage distribution in parentheses. Number of returns in thousands.
4/ Less than 0.1%.

Table 4B - Distributional Effects of $700 Cap Proposal Compared With 1984 Present Law by Filing Status--Average and Percentage Tax Change

(1982 Income Levels)

Expanded Income Class 1/ ($000's)	Joint--Two-Earner		Joint--Other		Single & Head of Household		Total 2/	
	Average Tax Change for Returns Affected	Percent Tax Change 3/	Average Tax Change for Returns Affected	Percent Tax Change 3/	Average Tax Change for Returns Affected	Percent Tax Change 3/	Average Tax Change for Returns Affected	Percent Tax Change 3/
Under $10	—	—	—	—	—	—	—	—
10 - 20	—	—	—	—	—	—	$ 31	4/
20 - 30	—	—	—	—	$ 4	4/	135	4/
30 - 40	$ 43	4/	$ 45	4/	125	1.2%	111	0.2%
40 - 50	156	1.3%	156	1.5%	357	3.8	182	1.6
50 - 75	499	4.7	525	4.8	796	6.3	536	4.9
75 - 100	1,260	7.1	1,292	7.2	1,356	6.4	1,284	7.1
100 - 200	2,555	7.6	2,550	7.4	1,819	4.3	2,487	7.2
200 & over	3,655	2.9	3,611	2.7	1,887	0.9	3,448	2.5
Total	$ 643	2.4%	$ 800	2.8%	$ 464	1.0%	$ 654	2.2%

1/ Expanded income equals adjusted gross income plus excluded capital gains and various other tax preference items less investment interest to the extent of investment income.
2/ Total includes married filing separate returns that are not listed elsewhere.
3/ Tax change as a percentage of total positive tax liability within each class.
4/ Less than 0.1%.

Table 4C - Distributional Effects of $700 Cap Proposal Compared With 1984 Present Law by Filing Status—Amount of Tax Change

(1982 Income Levels, dollar aggregates in millions)

Expanded Income Class 1/ ($000's)	Joint—Two-Earner		Joint—Other		Single & Head of Household		Total 2/	
	Amount of Tax Change	Percentage Distribution	Amount of Tax Change	Percentage Distribution	Amount of Tax Change	Percentage Distribution	Amount of Tax Change	Percentage Distribution
Under $10	—	—	—	—	—	—	—	—
10 - 20	—	—	—	—	—	—	—	—
20 - 30	—	—	—	—	—	—	$ 19	0.4%
30 - 40	$ 6	0.2%	$ 5	0.2%	$ 77	12.2%	100	1.9
40 - 50	231	9.2	123	5.9	118	18.8	475	9.0
50 - 75	780	31.0	553	26.4	205	32.6	1,544	29.2
75 - 100	422	16.8	397	19.0	89	14.1	912	17.2
100 - 200	764	30.3	732	35.0	103	16.4	1,600	30.3
200 & over	314	12.5	284	13.6	36	5.7	635	12.0
Total	2,518	100.0	2,093	100.0	629	100.0	5,287	100.0

1/ Expanded income equals adjusted gross income plus excluded capital gains and various other tax preference items less investment interest to the extent of investment income.

2/ Total includes married filing separate returns that are not listed elsewhere.

Table 5A - Aggregate Change in Tax Liability by Income Class from Major Provisions of ERTA and TEFRA Compared to Changes Due to Inflation and Social Security Legislation. Changes Measured for Tax Year 1984. (1982 income levels, millions of dollars)

Expanded income class ($000's) 1/	Combined inflation increases 2/ and changes in social security 3/ (prior to 1983 legislation)			Legislated income tax changes		
	After 1979	After 1980	After 9/30/81	ERTA 4/	TEFRA 5/	NET
Under $10	$5,184	$3,853	$1,735	$-1,961	$9	$-1,952
10 - 20	14,137	10,016	4,638	-9,787	246	-9,541
20 - 30	17,066	12,268	5,834	-15,188	419	-14,769
30 - 40	15,708	11,260	5,411	-14,807	313	-14,494
40 - 50	10,584	7,583	3,769	-10,199	233	-9,966
50 - 75	10,836	7,537	3,727	-10,815	304	-10,511
75 - 100	3,719	2,510	1,248	-4,209	181	-4,028
100 - 200	4,311	2,843	1,416	-6,289	342	-5,947
200 & over	1,728	1,115	552	-6,182	486	-5,696
Total	$83,274	$58,985	$28,328	$-79,437	$2,534	$-76,903

1/ Expanded Income is equal to Adjusted Gross Income plus excluded capital gains and other tax preference items less investment interest paid to the extent of investment income.

2/ Revenue gain from not adjusting personal exemption, zero bracket amount, and rate brackets by 46.0, 28.6, or 14.7 percent. These adjustments correspond to actual and forecasted rates of CPI-U inflation measured concurrently over periods beginning with the date shown and ending with 1984. Revenue gain evaluated against 1979 tax schedules.

3/ Additional employee and self-employed payroll tax from ad hoc increases in the wage base above what would have occurred under indexing (equivalent in 1982 to $3,300 for the two increases that occurred after 1979 and to $1,800 for the single increase that occurred after 1980), and from increases in rates for employees from 6.13 percent to 6.65 percent in 1981 and to 6.7 percent in 1982, and from increases in rates for the self-employed from 8.1 percent to 9.3 percent in 1981 and to 9.35 percent in 1982. Does not include

Table 5B.—Aggregate Tax Changes for 1984, by Income Class, Net of Tax Increases from Inflation and Social Security (Excluding 1983 Changes), Under Present Law and Under the $700 Cap Proposal 1/

(1982 income levels, dollars in millions)

Expanded Income Class ($000's)	Present law with no changes						Cap the Third Year at $700					
	After 1979		After 1980		After 9/30/81		After 1979		After 1980		After 9/30/81	
Below $10	$3,232	(30%)	$1,901	(16%)	$-217	(-2%)	$3,232	(30%)	$1,901	(16%)	$-217	(-2%)
10 - 20	4,596	(10)	475	(1)	-4,903	(-9)	4,596	(10)	475	(1)	-4,903	(-9)
20 - 30	2,297	(3)	-2,501	(-4)	-8,935	(-12)	2,316	(4)	-2,482	(-4)	-8,916	(-12)
30 - 40	1,214	(2)	-3,234	(-5)	-9,083	(-13)	1,318	(2)	-3,130	(-5)	-8,979	(-13)
40 - 50	618	(2)	-2,383	(-6)	-6,197	(-14)	1,096	(3)	-1,905	(-5)	-5,719	(-13)
50 - 75	325	(1)	-2,974	(-7)	-6,784	(-15)	1,872	(5)	-1,427	(-3)	-5,237	(-12)
75 - 100	-309	(-2)	-1,518	(-9)	-2,780	(-16)	604	(4)	-605	(-4)	-1,867	(-11)
100 - 200	-1,636	(-6)	-3,104	(-11)	-4,531	(-16)	-35	(0)	-1,503	(-6)	-2,930	(-10)
200 & over	-3,968	(-13)	-4,581	(-15)	-5,144	(-17)	-3,332	(-11)	-3,945	(-13)	-4,508	(-15)
Total	$6,371	(2%)	$-17,918	(-6%)	$-48,575	(-16%)	$11,668	(5%)	$-12,621	(-5%)	$-43,278	(-14%)

1/ These figures are the effects of the legislated tax changes shown in the last column of Table 5B minus the figures in one of the corresponding first three columns of that table. The amounts do not include the effects of the 1983 social security legislation. Figure in parentheses is this change as a percentage of net tax liability (tax liability net of inflation and social security increases occurring after the date shown).

Table 6 - Marriage Tax Penalty for Two-Earner Couples Under Present Law and Under the $700 Cap for 1984

Income of husband	Income of wife				
	$10,000	$20,000	$30,000	$50,000	$100,000
$10,000					
Present law.....	$-121	-84	-146	-512	-2,360
$700 cap.....	-121	-84	-146	-496	-2,022
$20,000					
Present law.....	-84	90	388	557	-837
$700 cap.....	-84	90	496	841	-169
$30,000					
Present law.....	-146	388	606	1,110	185
$700 cap.....	-146	496	982	1,662	1,188
$50,000					
Present law.....	-512	557	1,110	2,290	2,007
$700 cap.....	-496	841	1,662	3,018	3,160
$100,000					
Present law.....	-2,360	-837	185	2,007	3,390
$700 cap.....	-2,022	-169	1,188	3,160	3,710

Notes:

The marriage bonus or penalty is the difference between the tax liability of a married couple and the sum of the tax liabilities of the two spouses had each been taxed as a single person. Marriage bonuses are negative in the table; marriage penalties are positive. It is assumed that all income is earned, that taxpayers have no dependents, and that deductible expenses are 23 percent of income and are allocated between spouses in proportion to income.

Table 7 - Aggregate Tax Changes Relating to Individual Income Taxes, Employment Taxes, and Excise Taxes from Legislation Enacted after 1980, Tax Increases from Inflation and Pre-1981 Social Security Legislation, and Tax Increases from the $700 Cap Proposal[1/]

(Billions of dollars)

Tax Changes Relating to Individual Income Taxes, Employment Taxes, and Excise Taxes	Fiscal Year 1984	1985	1986
I. ...from legislation enacted after 1980			
1. ERTA[2/]	$-104.6	-122.0	-152.6
2. TEFRA[2/]	19.5	20.0	20.0
3. Highway Revenue Act of 1982[2/]	3.8	3.9	3.9
4. 1983 Social Security Act[3/]	5.5	7.3	7.0
Total	-75.8	-90.8	-121.7
II. ...from inflation[4/] and 1972 and 1977 social security legislation[5/]			
1. starting after 1979	100.6	128.7	156.6
2. starting after 1980	72.4	98.3	123.8
3. starting after September 30, 1981	28.9	51.5	73.1
III. ...from post-1980 legislation in excess of bracket creep and pre-1981 social security legislation (II minus I)			
1. starting after 1979	24.8	37.9	34.9
2. starting after 1980	-3.4	7.5	2.1
3. starting after September 30, 1981	-46.9	-39.3	-48.6
IV. ...from the $700 cap proposal	6.2	7.1	7.6

1/ The tax change estimates are made under different economic forecasts and should be considered preliminary.

2/ Consistent with 1984 U. S. Budget estimates.

3/ CBO estimates.

4/ Revenue gain from not adjusting the personal exemption, the zero bracket amount, and the rate brackets for concurrent CPI-U inflation. Revenue gain evaluated against 1979 tax schedules.

5/ Additional employment tax from ad hoc increases in the wage base above what would have occurred under indexing, and from increases in FICA and SECA rates. FICA amounts include both employee and employer shares.

STATEMENT OF SENATOR DOLE

CAP ON THIRD YEAR TAX RATE CUT

This morning we are pleased to welcome the Honorable Donald Regan, Secretary of the Treasury, who will advise us as to the administration's position on the proposed $700 cap on the benefits that can be received under the third year of the individual rate cuts passed in 1981. I am confident that the members are aware of the President's views on this issue, but it is good to have an opportunity for the Treasury to set down for the record the reasons why they regard the third-year tax cap as the wrong move to make at this time.

I know that our members may disagree with one another on the merits of the third year tax cut, and on the specific proposal to limit benefits under that cut to $700 per tax return. In his testimony Secretary Regan points out some of the drawbacks with that proposal. For example, the cap proposal would raise taxes beginning at income levels of around $29,800 for single taxpayers who do not itemize, and around $39,200 for joint returns without itemized deductions. The figures are somewhat higher for those who do itemize, but the point is that the cap affects taxpayers who by no stretch of the imagination are "wealthy". In fact, the proposal would have very little impact on taxpayers with incomes over $100,000 inasmuch as those taxpayers generally already pay tax at the maximum 50-percent rate and would not benefit from the third year.

Other concerns that have been raised concerning the tax cap proposal include the impact on two-earner couples, the effect on small businesses organized as proprietorships or partnerships, and the anomalies in the rate structure that might develop. But the overriding focus should be on the fact that tampering with the individual rate cuts would be a major reversal of the progress we have made towards lowering tax rates and performing the Tax Code to broaden the tax base. The deficit problem offers Congress a challenge: to use the opportunity to continue improving tax compliance and enhancing tax equity by eliminating special privileges, provided that can be done in conjunction with spending restraints. To reverse course now on individual tax rates is precisely the wrong thing to do.

It would be particularly inappropriate to raise tax rates for any taxpayers so soon after we have agreed to repeal withholding on interest and dividends. To try to compensate for the revenue loss from withholding repeal by increasing tax rates for a certain income group is a backward policy if ever there was one. It says to the average taxpayer, "we don't have the determination in Congress to enforce the tax laws fully, so we are going to raise your tax rates to make up for the difference." That is bad tax policy and bad politics, and I agree with the President that the third year rate cut should be kept intact. If we need to raise revenues, we should turn to the other options the Finance Committee is examining today and tomorrow: better tax compliance and cutbacks in or elimination of tax preferences that have outlived their usefulness or are unjustified on equity grounds.

STATEMENT OF TAXPAYER COMPLIANCE, SENATOR BOB DOLE, JUNE 23, 1983

At today's hearing the Internal Revenue Service will release the results of their recent study of taxpayer compliance. According to that study, over $90 billion was lost in 1981 and more will undoubtedly be lost this year. I look forward to having the hard facts of this final study from which to work as we consider taxpayer compliance problems. That study shows that noncompliance remains the $100 billion problem of our tax law.

BACKGROUND

Last year, improving taxpayer compliance formed the core of the Tax Equity and Fiscal Responsibility Act of 1983. We made important improvements to the tax system in that bill. Nevertheless, substantial types of noncompliance were not addressed in the 1982 legislation. For example, the $9 billion we lose from noncompliance regarding illegal income was not addressed. Neither was the substantial gap related to underreported income by unincorporated business restricted.

CURRENT THINKING

The conference committee budget would call upon the Finance Committee to raise substantial revenue in 1984 and 1985 and even larger revenues in 1986. I have real reservations whether those revenue targets are realistic or desirable. But if we are to raise revenues, a number of compliance options ought to be reviewed.

The pamphlet prepared by the staff for this hearing identifies many of those options. Others will be identified by Assistant Secretary Chapoton and other witnesses. For example, the tax bar and accounting profession are devoting substantial resources to the study of taxpayer noncompliance.

I am not prepared to endorse any of these options today—I have not introduced a taxpayer compliance bill this year—but I do believe that we need to study all of these options very carefully. I hope that the Finance Committee will continue to explore these options. We cannot pretend that we solved the problem last year. We made real progress for the first time in 30 years, but much more remains to be done. As we consider tax legislation and tax reform in the current Congress, I hope we emphasize efforts to collect the taxes owed before we raise honest, overburdened taxpayers' taxes further.

I look forward to the testimony today.

PREPARED STATEMENT OF SENATOR SYMMS

Mr. Chairman, I am very pleased that we are holding hearings on an issue that is, in my opinion, of extreme importance to the middle-income taxpayers—the taxpayers who pay the largest portion of the Nation's tax bill.

The Democratic tax cut cap is bad news for middle-income taxpayers because it would drive a tremendous wedge between the tax brackets faced by middle-income taxpayers and permanently raise certain marginal tax rates.

While income up to $29,900 is taxed at rates no higher than 25 percent, income above the $35,200 level would be subject to rates of 37 percent or more. That is, the tax rate for income at roughly the $35,000 level would be 50 percent higher than the tax rate for income at a level of about $30,000.

Wealthy taxpayers would largely escape the impact of the Democratic tax cap since income above the $109,400 range is already subject to the top tax rates of 49 to 50 percent.

Middle-income taxpayers would lose a major portion of the tax relief scheduled under the Economic Recovery Tax Act. Marginal tax rates on taxable income between $35,000 and $100,000 would be reduced by 14 to 15 percent. By contrast, tax rates for the lowest and the highest income brackets would be reduced by approximately 25-percent. Thus, while the brackets at the top and bottom of the income scale receive the full tax rate reduction, the middle-income ranges would lose between 33 and 39 percent of the scheduled reduction. According to Treasury Department calculations, a four-person, one-earner family making $40,000 in 1980—$49,264 in 1983 if they kept pace with inflation—would face a tax increase of $896 between 1983 and 1988 under the Democratic tax cut cap.

Even with the full 25-percent tax cut, few middle-income families are scheduled to receive a net tax reduction. A family of four with 1982 income of $40,000, for instance, will pay $52 in additional taxes this year as compared to 1980 tax rates. This increase results from bracket creep and Carter administration payroll tax hikes. The Democratic tax cap, coupled with new social security tax increases, the gasoline tax, and provisions of the 1982 tax bill would make this net increase much sharper.

The O'Neill tax cut cap is also bad medicine for the economy. Steeply progressive tax rates at the middle-income range would generate strong disincentives to work, save, and invest. Middle-income taxpayers above $30,000 would likely think twice before substituting extra work for leisure, knowing that all additional income will be taxed at 50 percent higher tax rates.

Likewise, the O'Neill tax cut cap would discourage saving and investment. The percentage of family income derived from savings and investment for families earning $50,000 and over is twice the national average—10.7 percent versus 5.2 percent. Hence, the O'Neill cap could inhibit an important source of capital for business investment, while driving up interest rates for consumer loans.

Small businesses would also be severely impacted; 86 percent of all small business pay only personal income taxes. Many of these would be affected by the tax cut cap and the skewed tax rate schedule it establishes. Relatively higher small business taxes would result in increased unemployment. During 1979–81, for instance, small firms with 500 or fewer employees accounted for 60 percent of the 2.8 million jobs created in The United States.

In addition, the tax cut cap may actually increase Federal deficits. To the extent the tax cut cap discourages economic growth, Federal revenues may be negatively impacted. Capping the tax cut for certain middle-income taxpayers may in fact reduce the relative amount of tax revenues collected from this group. In fiscal year 1982, the first full year in which the top marginal tax rate was lowered from 70 to

50 percent, upper-income taxpayers paid a larger percentage of total income taxes. Total U.S. taxes collected from those who make estimated payments—typically those in the highest brackets—increased from 27 to 29 percent.

Obviously, the idea of capping the third year of the tax cut is a bad idea not only because it is bad for middle-income taxpayers but also because it is a bad idea for the economy.

It is not doing away with a tax cut for rich people, as we have so often been told. This idea will raise taxes on middle-income taxpayers—the taxpayers who pick up most of the Nation's tax tab now.

Mr. Chairman, I think we should kill this idea and start working on ways to reduce the uncontrolled growth in Federal spending. We don't need to raise taxes. We need to cut spending. The private sector—corporations and small businesses alike—and the consumers have all tightened their belts and got in shape. The only sector that has increased its appetite is the Federal Government and it needs to be put on a diet. If not, I believe we are going to starve the taxpayers, the producers in our economy, into extinction.

STATEMENT OF SENATOR MAX BAUCUS, SENATE FINANCE COMMITTEE, JUNE 23, 1983

Mr. Secretary, welcome. Let me start by congratulating you on recent improvements in the economy.

Recovery finally has come. Economic indicators show that productivity is increasing, unemployment is decreasing, and inflation remains low. So far, so good.

But huge deficits could abort the recovery. The Federal deficit will exceed $200 billion this year and next year; and the year after that.

At the rate we're going, we'll accumulate more national debt during our next 6 years than we accumulated during our first 207. This creates problems.

Once recovery is well underway and private borrowing increases, such huge deficits will "squeeze out" private borrowing. Interest rates will rise. And if they rise too high, we could experience another disastrous "double dip" recession like 1980's.

Given this situation, our economic policy should have two objectives.

Our primary objective should be to achieve a strong recovery.

Our secondary objective should be to reduce the deficit, especially in the so-called "out years" between 1985 and 1988.

What does this mean for tax policy? It means, most importantly, that we must not repeal this year's scheduled tax cut. As it turns out, that cut mainly benefits lower- and middle-income taxpayers. What's more, it provides an important extra boost to recovery.

The same goes for indexing.

Indexing makes sense. It forces Congress to make clear public decisions about taxes. And it prevents "bracket creep" from creating an invisible middle-class tax increase.

Thus, in the short term, we must resist tax increases, like repealing the third year or repealing indexing, that could abort recovery. But in the long term, we must keep emphasizing deficit reduction.

As you know, deficit reduction depends on largely on spending cuts. But as you also know, it also depends on some revenue increases.

The question is what kind?

Several months ago, there was a lot of talk about repealing the third year of the tax cut. In that situation, a $700 cap seemed a preferable alternative. Accordingly, I supported it.

Now, it's unlikely that the cut will be repealed. So the question is how a cap compares to other possible long-term revenue increases, such as the administration's proposed surtax and oil surcharge.

I welcome the opportunity to investigate this question.

The CHAIRMAN. Mr. Secretary, we are pleased to have you here this morning, in anticipation of the Senate taking up the cap on the third year of the tax cut. The House bill probably will not get to this committee. I assume there will be an effort made to hold it on the floor.

It seemed to me it might be a good idea to have the administration make clear to us your views on the cap and whether or not you support the efforts by some in the House to cap the third year of the tax cut.

You have an opening statement. I think that first of all—I would like to see if any members would like to make a comment before you start. Is that satisfactory with you?

Secretary REGAN. Certainly so.

The CHAIRMAN. I don't have the early bird calendar here, but anybody who wanted a glass of water, too bad. [Laughter.]

The CHAIRMAN. Do you want your water now, or do you want to wait? [Laughter.]

The CHAIRMAN. I think the earliest bird is Senator Symms.

Senator SYMMS. Well, Mr. Chairman, I don't want to belabor the committee. I did want to make a brief opening comment, and I will try to cut it down as short as possible and ask unanimous consent that the entire statement be put in the record.

Mr. Secretary, I appreciate you coming over here this morning; I know you are very busy. But I do think that the subject is very important to middle-income taxpayers, who are the taxpayers who pay the largest portion of the Nation's tax bill.

Now, this tax cap that is being pushed by the Speaker and the Democratic Party in the House I think is bad news for middle-income taxpayers, because it will drive a tremendous wedge between the tax brackets faced by middle-income taxpayers and permanently raise certain marginal rates.

While income up to $29,900 is taxed at rates no higher than 25 percent, the income at a $35,200 level would be subject to rates of 37 percent or more. And that is, the tax rate for an income at roughly the $35,000 level would be 50 percent higher than the tax rate at an income of $30,000.

Now, they talk about this affecting the wealthy taxpayers. The wealthy taxpayers would largely escape the impact of Speaker O'Neill's tax cap, since the income above the $109,400 range is already subject to top tax rates of the 49 to 50 percent. So I just think that the middle-income taxpayers would stand to lose a major portion of the tax relief which is scheduled for them under the Economic Recovery Act, and it would be a terrible mistake.

I appreciate the Secretary being over here, and I think I can anticipate what he may say.

I would ask at this time, Mr. Chairman, for unanimous consent to put the remaining part of my remarks in the record if the Secretary has to leave here by 11 o'clock.

The CHAIRMAN. He is willing to stay beyond 11 o'clock but we do have another hearing scheduled at 10 o'clock. But we will delay that hearing, of course, until we finish.

Senator SYMMS. I just think we ought to kill this idea, Mr. Chairman, and I will just close by saying that. I think we should kill the idea and start working on ways to reduce the uncontrolled growth in Federal spending. And in order to do that, we don't need to raise taxes. We need to cut spending.

The private sector—the corporations and small businesses alike and the consumers have all tightened their belts to get in shape, and the only sector that has increased its appetite is the Federal Government, and it needs to be put on a diet.

Now, I don't know what all can be done unless we will be willing to tackle the entitlement spending programs. I just had the privilege of returning $147,000 to the Secretary this morning from run-

ning my office. I know that doesn't go very far toward balancing the national budget, but I do think that if we looked at all parts of the Government we could do better than we are doing on the spending. The tax rate is already 19 percent of the GNP, and the spending rate is 25 percent of the GNP. And the Congress has chosen to balance the budget by borrowing more money or asking the Federal Reserve to buy Treasury bills, and paper would overcounterfeit the currency. I think that's the wrong way to go. We don't need any more taxes; we just need to reduce spending.

I hope that we can really start approaching it from that angle. Thank you.

The CHAIRMAN. Thank you, Senator Symms.

Senator Roth is next on the early-bird list. Do you have a brief opening statement?

Senator ROTH. Five minutes.

Mr. Secretary, I just can't believe that at this late date the very people who were responsible for giving the rich their tax cut, reducing the marginal rate from 70 to 50 percent in the first year, are now proposing to cap the tax cut for the working people of America. It amounts to nothing more than a legislative mugging of the middle class.

The only thing that gives me some assurance or helps protect the American taxpayer is the fact that the President has said he will veto it.

I'm happy to say that some weeks ago I went over to the White House and handed a letter to the President with 34 signatures saying that we will sustain that veto. And that, in the final analysis, is what is going to protect the American taxpayer.

In all my years of service in the Senate I can't recall a proposal so full of misstatements and half-truths.

Just let me remind you of a few of the facts that somehow have been forgotten in this mad rush to sock the middle class.

This measure will raise taxes. It will raise taxes on over 8 million tax returns by an average of $854 per return per year. Nearly half of those returns affected by that $700 cap are filed by taxpayers earning less than $50,000.

Mr. Secretary, on the Senate floor last week, when we were talking about a pay increase for Members of the Senate, $60,000 wasn't considered to be "rich." It was not enough.

The fact is that two-income married families are going to feel like they got slugged by Larry Holmes when they figure out what some in Congress are trying to do to them. Nearly half of the revenue—let me repeat, nearly half of the revenue—that will be raised by the cap will come from two-earner married families.

Finally, Mr. Secretary, isn't it true that if you make more than $109,000 you won't even be affected by this cap, because the House of Representatives has already made sure they authored the law that cuts their taxes?

This measure won't penalize the rich; it penalizes the working men and women, some of the brightest, most innovative, hard-working people of America.

So Mr. Secretary, I have only one request this morning. Tell the President to hang in there and send this proposed tax increase down to anonymity, as it so richly deserves.

The CHAIRMAN. Senator Long, you are the next earlybird.

Senator LONG. Mr. Chairman, I came here because I thought the Secretary was supposed to testify, and I'll be pleased to hear his views.

Of course, I am always willing to hear my colleagues, but I'm fairly familiar with their views, and I'm not going to impose mine on them at this time. I think they know what I think about these matters, and I will withhold any further statement until we hear the Secretary make his statement.

The CHAIRMAN. All right. Well, this is sort of a testimonial affair here.

Senator Mitchell?

Senator MITCHELL. Well, Mr. Chairman, I came with the same intention as Senator Long, but I cannot help commenting that it appears that the English language has lost its meaning, based upon the statements we have heard here today.

The first statement was made that this tax would affect the middle class. The second statement made was that it would affect the working people of this country. The fact of the matter, of course, is that it will affect only 10 percent of all tax returns, the top 10 percent. And if 10 percent of top tax returns are the middle class and the working people of this country, who are the other 90 percent who have incomes lower than that?

It is of course preposterous to suggest—it is absurd, it is contrary to the facts and reality—that this tax cap will affect only the middle class and the working people of America. And every person in this room and every person in this country knows that.

If you have 100 percent of the taxpayers, and the top 10 percent represent the middle class and the working people, then it is a sorry state in this country when the bottom 90 percent don't even qualify. If that's true, then we've got a much, much larger lower class and lowerincome group in America than anybody has ever previously recognized until now.

I look forward to your testimony, Mr. Secretary, but I hope that from now on, for the remainder of the hearing, we will use the English language in accordance with what we all understand to be reality.

Thank you, Mr. Chairman.

The CHAIRMAN. That was a fine contribution. Thank you. [Laughter.]

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. Mr. Chairman, I have no statement at this time. I will have a number of questions for the Secretary when he finishes.

The CHAIRMAN. Now, Mr. Secretary, we are pleased to have you here. There always are these little opening sallies. I have a nice statement that I will put in the record.

Secretary REGAN. Thank you. I appreciate that, Mr. Chairman.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY, WASHINGTON, D.C.

Secretary REGAN. I do welcome this opportunity to meet with you today to provide the administration's views on capping the

third year of the 25 percent across-the-board individual income tax reduction enacted in 1981.

I understand that later on today the House will be voting on H.R. 1183, a bill to cap the third year of the tax reduction at about $700. Hopefully, the Members of that body will cast a vote to sustain economic recovery rather than oppose a retroactive, counterproductive, and unfair tax increase.

Before discussing the substance of the proposal to cap the third year of the tax reduction, let me take a moment or two to review the current economy and to clarify the administration's expectations both for the contingency tax plan recommended by the President earlier this year and tax indexing enacted by Congress in 1981.

There are a number of positive signs that the economic recovery is progressing well. The Department of Commerce's earlier unofficial estimate of the second quarter growth has real GNP up at an annual rate of 6.6 percent, compared with the first quarter rise of 2.6 percent and a decline that occurred in the fourth quarter of last year.

Components of this second quarter growth include a sharp increase in real consumer spending, a continued boom in residential construction, and a rebound in business capital spending. Also, the index of leading indicators has risen in each of the last 10 months, real wages are increasing, and unemployment is decreasing—although not at a fast enough rate as yet.

It is of the greatest importance that we not jeopardize this recovery by tax increases now.

The good news regarding current economic performance is one indication that the policies we put in place over 2 years ago are working. However, we recognize that with the ongoing recovery and its beneficial effects of helping to lower the forecast of deficits, we will still have significant long-term budget deficits.

I for one do not believe deficits are caused because taxpayers do not pay enough taxes. The long-term deficits exist because Government spending has grown a lot more rapidly than receipts over the last 20 years.

Government spending, as a percent of gross national product, is running above 25 percent this year and will remain at about 24 percent in 1984. By comparison, spending levels in the 1970's averaged less than 21 percent. Taxes are now about 19 percent of GNP, at approximately the same level as in the 1970's.

These trends clearly underscore the fact that the problem is one of overspending and not undertaxing.

In the fall of 1980 the American public gave this administration a clear mandate to reduce the size of Government, because the public correctly perceives the deficit problem is a spending problem and not a tax problem. This fact makes it all the more important to enact the President's proposed budget.

Long-term deficits remain a concern. They may not prevent recovery, but they will dampen the long-term rate of growth. They could prevent interest rates from dropping, and they could reduce investments.

It is because of the problems associated with substantial long-term deficits that we continue to suggest a contingency tax plan for

fiscal years 1986 through 1988. The President's contingency tax plan, an insurance policy for the economy, is a plan for fiscal responsibility. If Congress ducks the responsibility entrusted in them by the electorate, if there is no plan or commitment to reduce the long-term deficit, then the conditions necessary for sound and orderly long-term financial and economic health will be replaced by uncertainty and doubt on the part of individuals and businesses.

The deficit must be attacked through a balanced program of growth, revenues, and spending reductions; however, we cannot have an enactment of this contingency tax plan until Congress first adopts spending cuts such as the President has proposed. We do not intend that contingency tax revenues be used to finance more Government spending; instead, they must be used to reduce our debt.

Further, the contingency taxes will not take effect until fiscal 1986. Any tax increase before then, particularly any limitation on the third year of the tax cut, would be the wrong medicine for the economy.

As I have mentioned, the rebound from the recession has clearly begun. It is not just the administration but a broad majority of economists and businessmen who read the current statistics as evidence that the recession has ended. Although these signs represent very good and encouraging news, we still have a long way to go for full recovery.

As we are all painfully aware, unemployment remains at over 10 percent. Our Nation's factories are still operating at only 72 percent of capacity. Even with the strong growth reported for the current quarter, the level of real output is still only 1.5-percent higher than it was at the end of 1979.

This is not yet a sufficiently vigorous economy that we can risk reducing consumer confidence by raising taxes. Indeed, the full third year of the President's tax cut will be just the impetus that consumers need to maintain and invigorate the recovery.

Just as bad as the ill-advised timing of a limit on the third-year tax cut, limiting the benefits from the third year of the rate reduction would impair the vitality of the economy in the long run. That would permanently retain in the tax structure some of the disincentives to work and save that the 1981 Economic Recovery Tax Act removed.

Across-the-board marginal rate cuts is what we need to stimulate the savings and the work effort that will cause our country to avoid the slow growth and declining productivity of the last decade.

The President's policies must not be reversed just as the recovery is clearly underway. The third year of the tax cuts enacted under ERTA, restraint in Government spending, and the assurance of a marked downward trend in deficits in the 1986–88 period are needed now as much as they ever were. Any divergence from this plan could upset the process that is just beginning to work.

In addition to proposals to cap the tax cut, suggestions have been made—which I know will be made again—to prevent tax indexing from taking effect in 1985, as the current law requires.

Repeal or postponement of indexing would be a most irresponsible budget policy. Indexing simply keeps the Government from profiting from inflation. It stands in the path of the big spenders

who would like to have taxes continue to grow faster than income, and to do so automatically.

Indexing insures that if Congress tries to increase spending they have to raise the required revenues by voting on new taxes and not simply by accepting the combination of inflation and enaction.

Our success in reducing inflation should never be taken for granted. Surely we should not return to a system that rewards inflationary policies with automatic tax-rate increases.

Further, the repeal of indexing will increase the relative tax burdens on the lowest income taxpayers. For example, if indexing is repealed and inflation is 4.5 percent, those earning less than $10,000 will have their taxes increased by 9.4 percent, while those earning more than $100,000 will have their taxes increased by only 1.1 percent. Seventy-eight percent of the entire revenue gained from repeal of indexing would be borne by those earning less than $50,000.

And now turning to the proposal to cap the third year of the tax cut. As I have stated, a tax increase this year, or next, would be particularly harmful to the economic recovery now taking place.

Because there has been a well-publicized discussion of the notion that capping the third year of the tax cuts is good policy, I would like to take this opportunity to correct several misunderstandings as to what such a policy would do.

Proponents of a cap apparently wish to make people believe that a cap on the third year will make the rich, and only the rich, pay more taxes. This notion is simply not true. A $700 limit on the amount of the tax reduction will hit squarely at our great middle-income class. The truth is that just about half of the 8 million returns that would be affected by a $700 cap are filed by single individuals and married couples earning less than $50,000. And this first chart, Mr. Chairman, illustrates that.

Here, in orange, you have the returns of $50 to $99,000, those above $100,000; but the green here shows 48 percent, nearly 4 million returns, below $50,000 that would be affected by that tax cap. Forty-eight percent—47.8, to be specific. Almost half are affected.

Senator SYMMS. How does that square with the 10-percent figure we heard?

Secretary REGAN. I don't know what that 10 percent was.

Senator SYMMS. That's 48 percent of 10 percent. That's how it squares.

Senator Bradley: And that equals what percent?

Secretary REGAN. Well, roughly 5 percent.

Senator BRADLEY. Five percent, right? Not 48 percent.

Secretary REGAN. Forty-eight percent of those affected by the tax cap are below $50,000 of income.

Senator BRADLEY. And what percent of the total number of taxpayers is that?

Secretary REGAN. Of the total number of taxpayers, approximately 5 percent.

Senator BRADLEY. Five percent. So 95 percent of the taxpayers aren't hit?

Secretary REGAN. Pardon?

Senator BRADLEY. Ninety-five percent of the taxpayers aren't hit?

Secretary REGAN. Are not hit? That is correct.

Senator MITCHELL. No, that's not correct. That's not correct. Ninety percent aren't hit; 10 percent are hit.

Secretary REGAN. Excuse me, Senator, you are right. The 5 percent refers to those above $50,000. Right.

Based on our estimates, the $700 cap would increase taxes for the 8.1 million tax returns by an average of $654. But the unfair impact of a cap on middle-income families and single individuals is perhaps more clearly illustrated by example. Each of the examples that I am providing is for people who will be earning the average wage for their profession in 1984.

Now, my first example: A married couple consisting of a police officer who earns $23,260 and a registered nurse earning $20,960 would have received a tax reduction in 1984 of $917 if they did not itemize their deductions. Instead, the cap will result in a loss of $197 that they otherwise would spend on consumption, or save.

Now, it's ironic that that $197 tax increase over the current law roughly offsets 30 percent of the $691 tax benefit from the 10-percent, second-earner deduction that Congress enacted to help maintain incentives for the two-earner families.

Now the next example: A secretary earning $13,950 married to a chemical engineer earning $36,120. They would jointly have a 1984 tax reduction of $1179 if they did not itemize deductions. The cap would cut this reduction back by $459. If the couple did itemize, on average, an amount of deductions on their tax return, then the cutback in their scheduled tax reduction would be smaller but would still result in a tax hike of $134, compared with the present law.

Example three: Two public school teachers, each earning $20,670, will have $83 lopped off their tax reduction.

And the fourth example: A single person earning $32,500 as a sales manager, or even as a GS–12 in the Federal Government, who does not itemize deductions would have his 1984 tax cut pared back by $108.

I want to stress that each of these examples is based on the average earnings for each occupation given. But please note in these examples how much this proposal hits at families with working spouses.

Working couples account for 4 million of the 8 million tax returns that are affected by the cap. Roughly one-half of the total revenue that would be raised by the cap represents increased taxes on working couples.

We prided ourselves over the past two decades at finding jobs for the second worker, and in the 1981 tax law we tried to work things out to even them out for married workers. Now this proposal would undo much of that. That's retrogression, not progress.

Proponents of a cap also would like people to believe that a cap merely reduces a future tax cut that the American taxpayer is yet to receive. That's wrong. Although the examples I have just presented apply to taxes in 1984 when the tax reductions enacted under ERTA would be fully phased in, a cap on the third year of the tax reductions would actually raise tax rates, in effect, for calendar year 1983 as well as in 1984, and for each of the years thereafter.

A third year cap amounts to a retroactive tax increase for millions of taxpayers who have been relying on the 1983 tax rates which have been the law since January 1 of this year.

Marginal tax rates for 1983 are increased 2 percentage points for each tax bracket between $35,200 and $109,400 of taxable income on a joint return schedule, and $55,300 of taxable income on the single return individual.

Returning to example one for a moment, the police officer and the registered nurse who have a 1984 tax increase of $197 on their 1984 family income of $44,000 would also have a 1983 tax increase of $57 on their 1983 income.

The couple consisting of a secretary married to the chemical engineer would have their 1983 tax cut reduced by $182.

I would like to point out that imposing a cap on the third year is not a simple matter of placing a limitation on tax refunds. A cap results in a permanent marginal tax rate increase that would affect taxpayers on withholding, taxpayers making estimated tax payments, taxpayers with end of the year refunds, and taxpayers making end of the year final tax payments. A cap on the tax cut, therefore, requires revising each of the tax rate schedules that apply to single individuals, married couples filing jointly, married people filing separate returns, and heads of households.

As you can see from the examples I have cited, because of the need to round the tax rate to the nearest full percent the actual cap for joint returns would be $720. A similar technical problem exists for single returns. In order to have the cap apply at the same place on the single person's rate schedule as it applies on the joint rate returns, the cap for single people will work out to be $637—that is, since the $700 cap first affects the joint rates of the 33-percent bracket rate, a comparable rate for singles would first affect their rates at the 34-percent bracket.

The cap tax rate schedules that would remain permanently in the tax law would be sharply more progressive throughout their middle ranges than current law rates. This is because a cap rate schedule must rise quickly at the point the cap applies in order to limit the reductions to $700.

This increased steepness in the marginal tax rates would apply initially only to upper middle incomes. But as the whole distribution of income gradually moves up over time, it would not be long before the vast range of middle-income taxpayers became subject to these highly progressive tax rates.

Let me illustrate that in my final chart, Mr. Chairman. As you can see, under current law, when taxable incomes on a joint return reaches $35,200, there is a 5-percentage point jump in the marginal tax rate currently, from 28 to 33. Under the cap rate schedule, this becomes a 9-point jump, from 28 to 37—this whole distance the rates would move up, in here, from 28 to 37 on the first dollar of income above that level.

The chart also illustrates the fact that the cap rate schedule would have joint returns reaching the top 50 percent rate two brackets sooner than under current law. You can see that the rate would be hit right here at the $85,000 income bracket. That would now become the 50-percent margin, rather than, as currently, out here at 160. That's two brackets sooner. And the same thing ap-

plies of course over in here to the other rates. You see the steepness in the middle brackets in here.

Not only would average working families and individuals in a host of professions feel the pinch of the cap, but the $700 tax cut ceiling would also affect scheduled tax reductions for small businesses.

Small businesses, which are a vital source of employment and investment, are almost always taxed at the individual income tax rates. Only 14 percent of all small businesses pay the corporate income tax. The remaining 86 percent are partnerships, sole proprietorships, or small corporations electing to be taxed as individuals. And they pay the individual income tax.

Overall, nearly 2.5 million small businesses, including 350,000 family farms, would have their taxes increased by a $700 cap. You realize, of course, Mr. Chairman, that farmers will be adversely affected by this proposal, yet we all know the difficulty farmers are having and what it is costing in Federal revenues to alleviate their current problems.

While it is true that almost half of all taxpayers who would be hit by the $700 cap earn less than $50,000, it is also true that those with the very highest earnings will lose a relatively small part of their overall 3-year tax cut. That's because the top rate was reduced from 70 to 50 percent all at once on January 1, 1982.

What happens to the American dream of the middle class under this proposal? As I have shown you by a few examples, those who are trying to get ahead by having two workers in the family to pay for a better house or educating children are to be penalized by ill-conceived tax legislation. There is no use trying to earn more; Congress will tax it away. That's not fair to the middle class. This bill may be aimed at the wealthy, but it hits at the middle class.

In conclusion, I urge this committee to reject this proposal. It is bad economics, bad tax policy, it hits hardest at working spouse, and is simply unfair.

However, Mr. Chairman, I do stand ready to work with you and with this committee to achieve reductions in the Federal deficit. This administration welcomes your suggestions on how we can meet the problems of the outyear deficits and where reductions can be made. A motivation in preparing the contingency tax was to show the American people that if we were to ask them to provide additional revenues for reducing deficits, so too would we be asking the Congress to join us in making reductions.

There are no easy solutions, but I am confident we can meet the challenge.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

I welcome this opportunity to meet with you today to provide the Administration's views on capping the third year of the 25 percent across-the-board individual income tax reduction enacted in 1981.

I understand that later on today the House will be voting in H.R. 1183, a bill to cap the third-year of the tax reduction at about $700. Hopefully, Members of that body will cast a vote to sustain economic recovery rather than to impose a retroactive, counterproductive, and unfair tax increase.

Before discussing the substance of the proposal to cap the third year of the tax reduction, let me take a moment or two to review the current economy and to clarify the Administration's expectations for both the contingency tax plan recommended by the President earlier this year and tax indexing enacted by the Congress in 1981.

ECONOMIC RECOVERY AND THE DEFICIT

There are a number of positive signs that the economic recovery is progressing well. The Department of Commerce's early unofficial estimate of second quarter growth has real GNP up at an annual rate of 6.6 percent, compared with the first quarter's rate of 2.6 percent a decline that occurred in the fourth quarter of last year. Components of this second quarter growth include a sharp increase in real consumer spending, a continued boom in residential construction, and a rebound in business capital spending.

Also, the index of leading indicators has risen in each of the last 10 months, real wages are increasing, and unemployment is decreasing, although not at a fast enough rate as yet. It is of the greatest importance that we not jeopardize this recovery by tax increases now.

The good news regarding current economic performance is one indication that the policies we put in place over two years ago are working. However, we recognize that, with the ongoing recovery and its beneficial effects of helping to lower the forecast of deficits, we will still have significant long-term budget deficits. I, for one, do not believe deficits are caused because taxpayers do not pay enough taxes. The long-term deficits exist because government spending has grown a lot more rapidly than receipts over the last 20 years. Government spending as a percent of GNP is running above 25 percent this year and remains about 24 percent in 1984. By comparison, spending levels in the 1970's averaged less than 21 percent. Taxes are now about 19 percent of GNP, approximately the same level as in the 1970's. These trends clearly underscore the fact that the problem is one of over-spending and not undertaxing.

In the fall of 1980 the American public gave this administration a clear mandate to reduce the size of government because the public correctly perceives the deficit problem as a spending problem and not as a tax problem. This fact makes it all the more important to enact the President's proposed budget.

Long-term deficits remain a concern. They may not prevent recovery, but they will dampen the long-term rate of growth, could prevent interest rates from dropping, and could reduce investment.

CONTINGENCY TAX PLAN

It is because of the problems associated with substantial long-term deficits that we continue to suggest a contingency tax plan for fiscal years 1986–88. The President's contingency tax plan—an insurance policy for the economy—is a plan for fiscal responsibility. If Congress ducks the responsibility entrusted in them by the electorate—if there is no plan or commitment to reduce the long-term deficit—then the conditions necessary for sound and orderly long-term financial and economic health will be replaced by uncertainty and doubt on the part of individuals and businesses alike.

The deficit must be attacked through a balanced program of growth, revenues, and spending reductions. However, we cannot have enactment of the contingency tax plan until Congress first adopts spending cuts such as the President has proposed. We do not intend that contingency tax revenues be used to finance more government spending. Instead, they must be used to reduce our debt.

Further, the contingency taxes will not take effect until fiscal 1986. Any tax increase before then, particularly any limitation on the third year of the tax cut, would be the wrong medicine for the economy.

As I have mentioned, the rebound from the recession has clearly begun. It is not just the administration, but a broad majority of economists and businessmen who read the current statistics as evidence that the recession has ended. Although these signs represent very good and encouraging news, we still have a long way to go for full recovery. As we are all painfully aware, unemployment remains over 10 percent. Our nation's factories are still operating at only 72 percent of capacity. Even with the strong growth reported for the current quarter, the level of real output is still only 1½ percent higher than it was at the end of 1979. This is not yet a sufficiently vigorous economy that we can risk reducing consumer confidence by raising taxes. Indeed, the full third year of the President's tax cut will be just the impetus that consumers need to maintain and invigorate the recovery.

Just as bad as the ill-advised timing of a limit on the third year tax cut, limiting the benefits from the third year of the rate reduction would impair the vitality of the economy in the long run. That would permanently retain in the tax structure some of the disincentives to work and save that the 1981 Economic Recovery Tax Act [ERTA] removed. Across-the-board marginal rate cuts for all is what is needed to stimulate the savings and the work effort that will cause our country to avoid the slow growth and declining productivity of the last decade.

The President's policies must not be reversed just as the recovery is clearly underway. The third year of the tax cuts enacted under ERTA, restraint in government spending, and the assurance of a marked downward trend in deficits in the 1986–88 period, are needed now as much as they ever were. Any divergence from this plan could upset the process that is just beginning to work.

INDEXATION OF THE PERSONAL TAX SYSTEM

In addition to proposals to cap the tax cut, suggestions have been made, which I know will be made again, to prevent tax indexing from taking effect in 1985 as current law requires. Repeal or postponement of indexing would be a most irresponsible budget policy. Indexing simply keeps the Government from profiting from inflation. It stands in the path of the big spenders who would like to have taxes continue to grow faster than incomes, and to do so automatically. Indexing ensures that, if Congress tries to increase spending, they have to raise the required revenues by voting on new taxes and not simply by accepting the combination of inflation and inaction. Our success in reducing inflation should never be taken for granted. Surely we should not return to a system that rewards inflationary policies with automatic tax rate increases.

Further, the repeal of indexing will increase the relative tax burden on the lowest income taxpayers. For example, if indexing is repealed and inflation is 4.5 percent, those earning less than 10,000 will have their taxes increased by 9.4 percent while those earning more than $100,000 will have their taxes increased by only 1.1 percent. Seventy-eight percent of the entire revenue gain from repeal of indexing would be borne by those earning less than $50,000.

PROPOSALS TO CAP THE THIRD YEAR OF THE TAX CUT

And now, turning to the proposal to cap the third year of the tax cut, as I have stated, a tax increase this year or next would be particularly harmful to the economic recovery now taking place. Because there has been well-publicized discussion of the notion that capping the third year of the tax cuts is good policy, I would like to take this opportunity to correct several misunderstandings as to what such a policy would do.

Proponents of a cap apparently wish to make peope believe that a cap on the third year will make the rich, and only the rich, pay more taxes. This notion is simply not true. A $700 limit on the amount of tax reduction will hit squarly at our great middle-income class. The truth is that just about half of the 8 million returns that would be affected by a $700 cap are filed by single individuals and married couples earning less than $50,000. (See Chart 1.) Some single taxpayers who do not itemize deductions will be affected, even though they earn no more than $30,000 of gross income.

Based on our estimates, a $700 cap would increase taxes for 8.1 million tax returns by an average of $654. But the unfair impact of a cap on middle-income families and single individuals is perhaps more clearly illustrated by example. Each of the examples I am providing is for people who will be earning the average wage for their profession in 1984.

Example 1.—A married couple consisting of a police officer who earns $23,260 and a registered nurse earning $20,960 would have received a tax reduction in 1984 of $917 if they did not itemize their deductions. Instead, the cap would result in a loss of $197 that they would otherwise spend on consumption or save. It is ironic that the $197 tax increase over current law roughly offsets 30 percent of the $691 tax benefit from the 10 percent second earner deduction that Congress enacted to help maintain incentives for two earner families. (See Chart 2.)

Example 2.—A secretary earning $13,950 married to a chemical engineer earning $36,120 would jointly have a 1984 tax reduction of $1,179 if the couple did not itemize deductions. The cap would cut this reduction back by $459. (See Chart 3.) If the couple did itemize an average amount of deductions on their tax return then the cutback in their scheduled tax reduction would be smaller but would still amount to a tax hike of $134 compared with present law.

Example 3.—Two public school teachers, each earning $20,670, would have $83 lopped off their tax reduction. (See Chart 4.)

Example 4.—A single person who earns $32,500 as a sales manager or as a GS-12 Federal Government worker and who does not itemize deductions would have his 1984 tax cut pared back by $108. (See Chart 5.)

I want to stress that each of these examples is based on the average earnings for each occupation given. Please note in these examples how much this proposal hits at families with working spouses. Working couples account for 4 million of the 8 million tax returns affected by the cap. Roughly one-half of the total revenue that would be raised by the cap represents increased taxes on working couples. We've prided ourselves over the past two decades at finding jobs for the second worker and in the 1981 tax law we tried to even things out for the married workers, now this proposal would undo much of that. It is retrogression not progress.

Proponents of a cap also would like people to believe that a cap merely reduces a future tax cut that the American taxpayer has yet to receive. This is wrong. Although the examples I just presented applied to taxes in 1984, when the tax reductions enacted under ERTA would be fully phased in, a cap on the third year of those tax reductions would actually raise tax rates in effect for calendar year 1983, as well as for 1984 and years thereafter. A third year cap amounts to a retroactive tax increase for millions of taxpayers who have been relying on the 1983 tax rates which have been the law since January 1 of this year. Marginal tax rates for 1983 are increased 2 percentage points for each tax bracket between $35,200 and $109,400 of taxable income on the joint return schedule and for each tax bracket between $28,800 and $55,300 of taxable income on the single return schedule.

Returning to Example 1 for a moment, the police officer and registered nurse who have a 1984 tax increase of $197 on their 1984 family income of $44,220 would also have a 1983 tax increase of $57 on their 1983 income of $42,050. The couple consisting of a secretary married to a chemical engineer (Example 2) would have its 1983 tax cut reduced by $182.

I would like to point out that imposing a cap on the third year is not a simple matter of placing a limitation on tax refunds. A cap results in a permanent marginal tax rate increase that would affect taxpayers on withholding, taxpayers making estimated tax payments, taxpayers with end-of-year refunds, and taxpayers making end-of-year final tax payments. A cap on the tax cut, therefore, requires revising each of the tax rate schedules that apply to single individuals, married couples filing jointly, married people filing separate returns, and heads of households.

As you can see from the examples I have cited, because of the need to round the tax rates to the nearest whole percent, the actual cap for joint returns would be $720. A similar technical problem exists for single returns. In order to have the cap apply at the same place on the single persons rate schedule as it applies on the joint return rates, the cap for single people would work out to be $637. That is, since the $700 cap first affects the joint rates at the 33 percent bracket rate, a comparable cap for singles would first affect their rates at the 34 percent bracket rate. (There is no 33-percent rate for single returns under current 1984 law. The 34-percent rate is the closest one to the joint rate schedule's 33-percent bracket rate.)

The capped tax rate schedules that would remain permanently in the tax law would be sharply more progressive throughout their middle ranges than current law rates. This is because a capped rate schedule must rise quickly at the point the cap applies in order to limit tax reductions to about $700. This increased steepness in the marginal tax rates would apply initially only to upper middle incomes but as the whole distribution of income gradually moves upward over time it would not be long before the vast range of middle-income taxpayers became subject to these same highly progressive tax rates. As Chart 6 shows, under current law when taxable income on a joint return reaches $35,200 there is a 5 percentage point jump in marginal tax rates—from 28 percent to 33 percent. Under a capped rate schedule, this becomes a 9 point jump—from 28 percent paid on income just under $35,200 to 37 percent paid on the first dollar of income just above that level. That chart also illustrates the fact that a capped rate schedule would have joint returns reaching the top 50-percent rate two brackets sooner than under current law.

Not only would many average working families and individuals in a host of professions feel the pinch of the cap but the $700 tax cut ceiling would also affect scheduled tax reductions for small business. Small businesses, which are a vital source of employment and investment, are almost always taxed at the individual income tax rates. Only 14 percent of all small businesses pay the corporation income tax. The remaining 86 percent that are partnerships, sole proprietorships, or small corporations electing to be taxed as individuals pay only the individual income tax. Overall, nearly 2½ million small businesses, including 350,000 family

farms, would have their taxes increased by a $700 cap. You realize, of course, Mr. Chairman, that farmers will be adversely affected by this proposal. Yet we all know the difficulties farmers are having, and what it's costing in Federal revenues to alleviate their current problems.

While it is true that almost half of all taxpayers who would be hit by a $700 cap earn less than $50,000, it is also true that those with the very highest earnings will lose a relatively small part of their overall 3-year tax cuts. This is because the top rate was reduced from 70 to 50 percent all at once on January 1, 1982.

THE EFFECT OF A CAP ON MARGINAL RATE CUTS

A crucial element of the President's tax program has been the reduction in marginal tax rates so as to encourage work and savings. Overall the tax cut program will reduce marginal rates by about 25 percent. Marginal rates have been cut 15 percent thus far and the remaining 10-percent cut will come on July 2. If the third year tax cut is capped, however, all of the third year's reduction in marginal rates will be repealed for many taxpayers.

If the third phase is not capped at $700, joint returns reporting taxable incomes between $35,200 and $45,800 will have received a reduction in the marginal rates of tax they pay equal only to 14 percent instead of 23.3 percent. For those with taxable incomes between $45,800 and $109,400 the marginal tax rate reductions would range from only 14.3 percent up to 15.3 percent if the third year is capped, as opposed to reductions of 22.4 percent up to 23.7 percent if there is no cap.

Looking at this over a period of years there will be some families and single individuals who will receive no reduction in their marginal tax rates whatsoever. For example, a family of four with one wage earner that had income in 1980 of $40,000 paid tax at the 37 percent marginal tax rate in 1980. If their income remains constant in real terms (that is, the wage earner receives cost of living wage increases, but nothing more), this family would be paying tax in 1984 at a marginal rate of 33 percent under current law. If the third year is capped at $700, however, they will be paying tax at exactly the same 37 percent marginal tax rate they faced in 1980, before all three phases of the tax cut were enacted. So this cap wipes out the gain there was in a lowered marginal rate.

What happens to the American dream of the middle class under this proposal? As I have shown you by a few examples, those who are trying to get ahead by having two workers in the family, to pay for a better house, or educating children are to be penalized by ill-conceived tax legislation. There's no use trying to earn more—Congress will tax it away—that's not fair to the middle class. This bill may be aimed at the wealthy, but it hits the middle class.

In conclusion, I urge this Committee to reject this proposal; it's bad economics, it's bad tax policy, it hits hardest at working spouses, and it's simply unfair. However, Mr. Chairman, I stand ready to work with you and with this Committee to achieve reductions in the Federal deficit.

This administration welcomes your suggestion on how we can meet the problems of the outyear deficits and where reductions can be made. Our motivation in preparing a contingency tax was to show the American people that if we were to ask them to provide additional revenues for reducing deficits, so too would we ask the Congress to join us in making reductions.

There are no easy solutions but I am confident we can meet this challenge.

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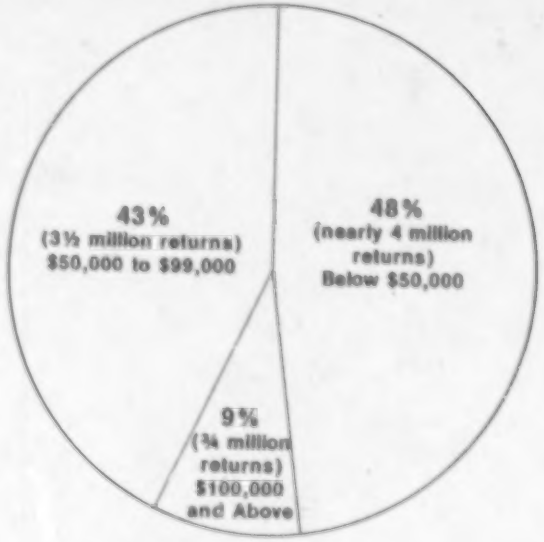
Chart 1

DISTRIBUTION BY INCOME CLASS OF TAXPAYERS AFFECTED BY THE CAP



Source: U.S. Treasury
June 14, 1983

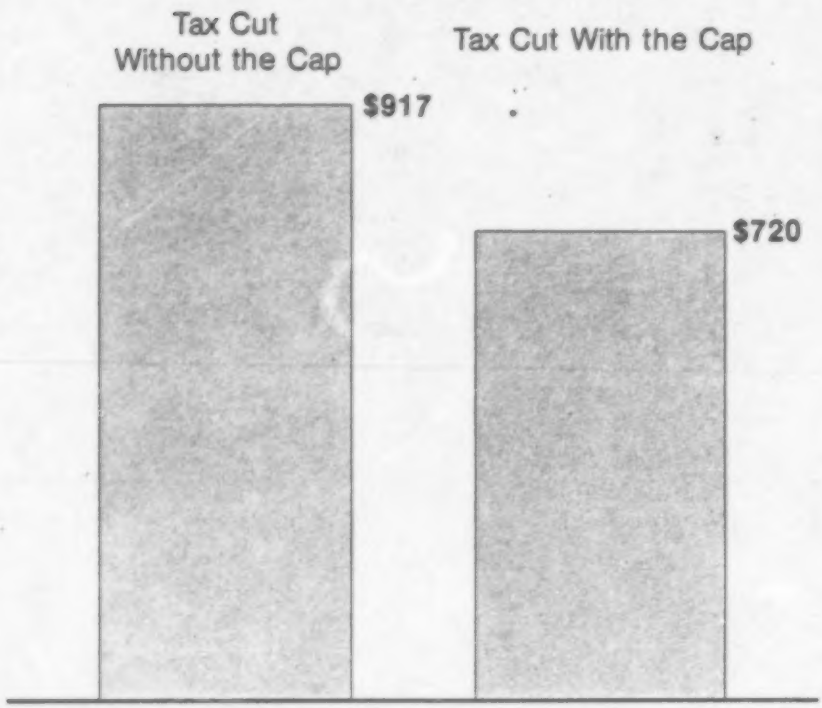
Chart 2

Example 1.

Married Couple

Occupation	Annual Income*
Police Officer	$23,260
Nurse	$20,960
Family Income	$44,220

Third-Year Tax Cut In 1984**



*Incomes shown are estimated average 1984 earnings for full-time workers in the occupations listed.

**Assumes no itemized deductions.

Source: U.S. Treasury
June 14, 1983

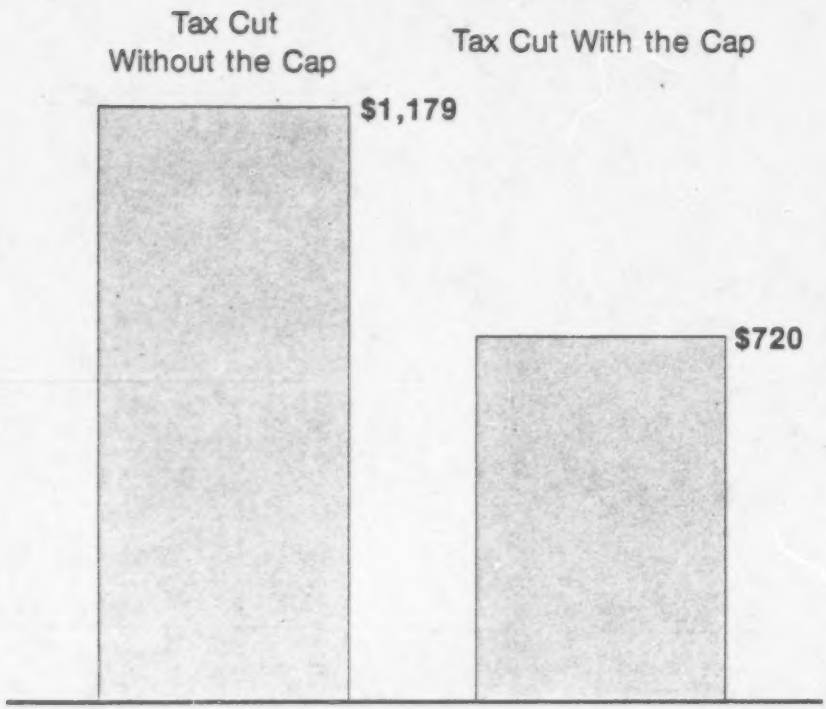
Chart 3

Example 2

Married Couple

Occupation	Annual Income*
Secretary	$13,950
Chemical Engineer	$36,120
Family Income	$50,070

Third-Year Tax Cut in 1984**



*Incomes shown are estimated average 1984 earnings for full-time workers in the occupations listed.

**Assumes no itemized deductions.

Source: U.S. Treasury
June 14, 1983

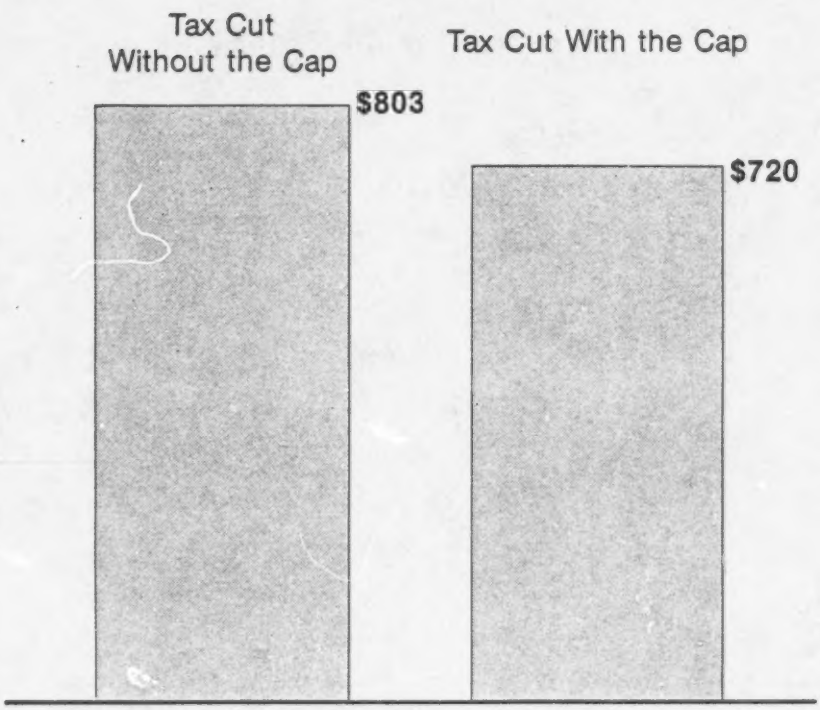
Chart 4

Example 3

Married Couple

Occupation	Annual Income*
School Teacher	$20,670
School Teacher	$20,670
Family Income	$41,340

Third-Year Tax Cut in 1984**



*Incomes shown are estimated average 1984 earnings for full-time workers in the occupations listed.

**Assumes no itemized deductions.

Source: U.S. Treasury
June 14, 1983

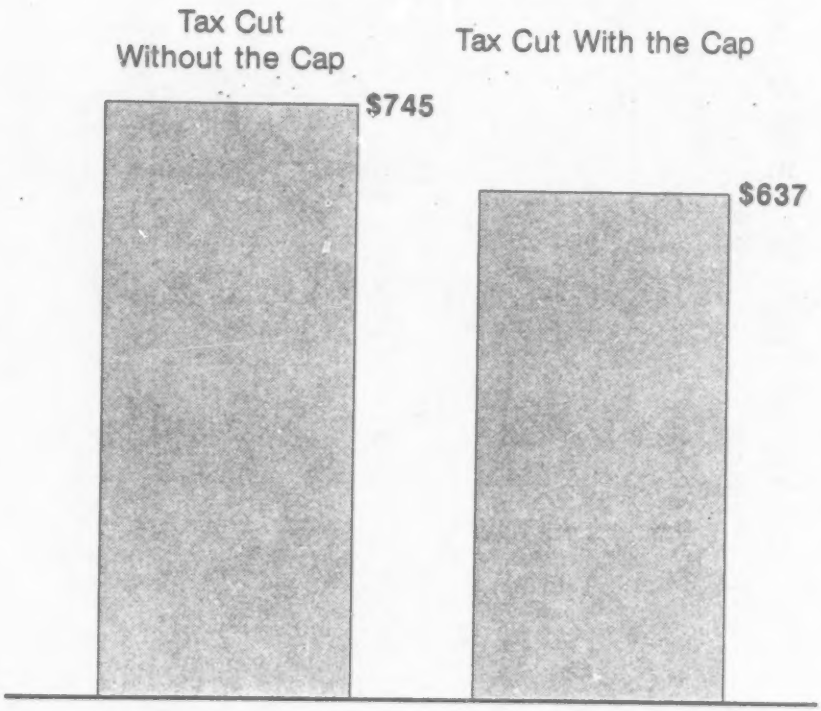
Chart 5

Example 4

Single Individual

Occupation	Annual Income*
Sales Manager or GS-12 Government Worker	$32,500

Third-Year Tax Cut in 1984**



*Income shown is estimated average 1984 earnings for full-time worker in the occupation listed.

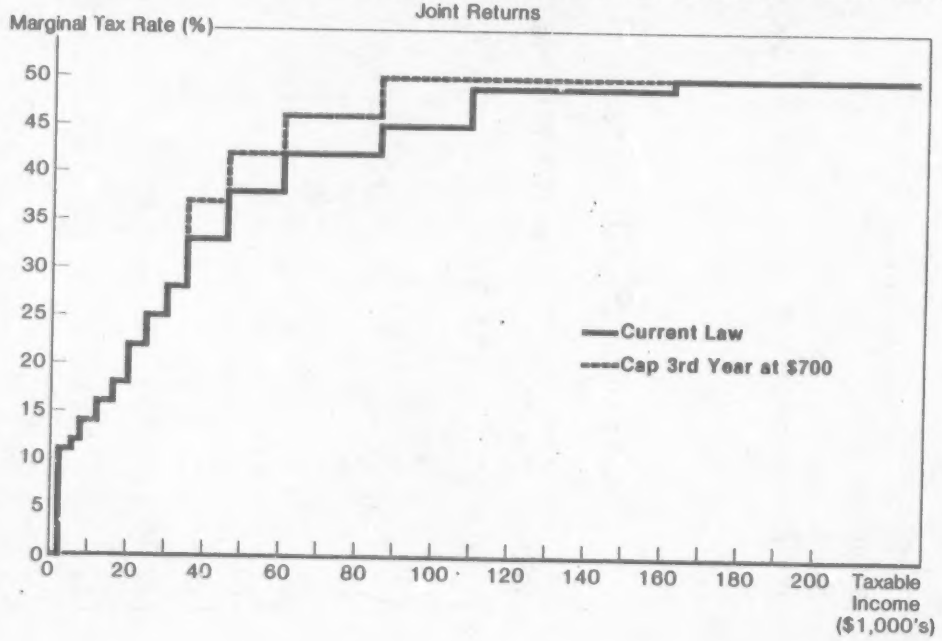
**Assumes no itemized deductions.

Source: U.S. Treasury
June 14, 1983

Chart 6

TAX RATES: STEEPER, HIGHER, EARLIER

MARGINAL TAX RATES BEFORE AND AFTER THIRD YEAR CAP



Source: U.S. Treasury
June 14, 1983

The CHAIRMAN. Thank you very much, Mr. Secretary.

Senator Bradley has an 11 o'clock commitment away from the Capitol, so I have agreed to recognize him for 5 minutes at this time.

Senator BRADLEY. Thank you very much, Mr. Chairman.

Mr. Secretary, are you in favor of any revenue increase in fiscal year 1984?

Secretary REGAN. Yes. We have proposed a cap on medical expenses that would raise approximately $2 to $2.5 billion per year in 1984 and on.

Senator BRADLEY. But the administration would not support any further revenue increase?

Secretary REGAN. No, Senator, we would not.

Senator BRADLEY. Are you still in favor of the balanced-budget amendment?

Secretary REGAN. The more I see of what is going on, Senator, the more I am inclined to favor that balanced-budget amendment. Yes.

Senator BRADLEY. Would you be in favor of it applying to your administration?

Secretary REGAN. Yes, I believe I would.

Senator BRADLEY. How would we get a balanced budget this year, with a $200 billion budget deficit, without a revenue increase of more than $2 billion?

Secretary REGAN. There is no way you could do it this year; we are just coming out of a recession. We all know that with the cyclical unemployment we have there is no way you could achieve a balanced budget at this particular moment.

Senator BRADLEY. Well, but the recovery is just around the corner.

Secretary REGAN. The recovery is here. It's not around the corner anymore.

Senator BRADLEY. So when would you like the balanced-budget amendment to apply?

Secretary REGAN. Well, as you know, there are 32 States—Missouri being the latest one—to have passed that amendment asking for the Constitutional Convention. It looks as though it would be 1984 before the State legislatures would get around to enacting it, if indeed the other two States are going to come along. So I suspect the Constitutional Convention would probably be in 1985.

Senator BRADLEY. But you hope that it doesn't apply at a time when you are facing $200 billion budget deficits?

Secretary REGAN. I think in 1985 we will still be here and facing it.

Senator BRADLEY. Let me ask you: Do you support the present distribution of tax burden in the present law?

Secretary REGAN. No. I do think that the tax burdens as they are now enacted could be more fair, and there could be a better distribution.

Senator BRADLEY. How could that distribution be more fair?

Secretary REGAN. Well, we are studying the problem. As you know, from your own work in this field, this is not an easy thing to decide. We at Treasury are deciding that, but we have come to no conclusions as yet. We do think there is a better way to do it.

Senator BRADLEY. Would it be fair to say that the proposals that you are considering would not increase the tax burden on middle income and lower income Americans?

Secretary REGAN. That's hopefully what we will arrive at. Yes.

Senator BRADLEY. And you could assure the committee that you would make no proposals that would increase the tax burden on lower and middle income Americans, the Americans that you are concerned about in this tax-cap argument?

Secretary REGAN. Well, I can't assure you forever that that would happen, because obviously if we get into any type of excise tax or anything of that nature in the future that will hit across the board and would affect those income brackets. But I am talking about in the field of personal income tax—no, we don't want to see them hurt with personal income tax.

Senator BRADLEY. So nothing that you would propose in personal income tax would increase the tax burden on lower and middle-income Americans?

Secretary REGAN. Philosophically, no; although we have no specific proposals. That's what I'm getting at.

Senator BRADLEY. Let me ask you for one further clarification on this cap. The numbers are, 90 percent of the taxpayers are not affected by this. Is that not correct?

Secretary REGAN. Yes.

Senator BRADLEY. The numbers are that everyone, whatever their tax bracket, gets $700 in tax reduction in July. Is that not correct?

Secretary REGAN. No; that's not correct, if you are not entitled to $700 in tax reduction.

Senator BRADLEY. Up to $700?

Secretary REGAN. To $700, yes.

Senator BRADLEY. Do you feel at all that the present tax system is unfair on an income scale of, say, $30,000 to $50,000?

Secretary REGAN. Yes. I think right now the stepup in the brackets and the like—you get very quickly into the 33 to 37 percent brackets now in that middle range, particularly if there are two wage earners in the family.

Senator BRADLEY. But nothing you are going to propose or would contemplate proposing would increase the tax burden on that income level?

Secretary REGAN. As far as I know, we have no such plans. No.

Senator BRADLEY. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Could I just follow up on that?

As I understand, the 10 percent who are not affected by the cap would pay, what? About 40 percent of the taxes?

Secretary REGAN. That is correct the 10 percent who are affected would pay about 40 percent of the taxes. I think I have a table on that.

The CHAIRMAN. I think when you start tossing around numbers, we ought to toss them all around. So it is a rather substantial tax burden that 10 percent carry. It is pretty much like farm programs—we talk about the "upper 10 percent."

Secretary REGAN. About 37 percent of taxes are paid by those in the $50,000 and above range, of the total amount of dollars.

The CHAIRMAN. So that is probably more meaningful than the other numbers.

Senator MITCHELL. Mr. Chairman, could I just ask if he would repeat that again? Did you just say that 88 percent of all taxes are paid by taxpayers making more than $50,000 a year?

Secretary REGAN. No. Eighty-eight percent of the cap will be charged to them, all right?

Of the total above $50,000—let's see——

Senator MITCHELL. A third.

Secretary REGAN [continuing]. Of the taxes come in that class, $50,000 and above.

The CHAIRMAN. All right. We will go back to the early-bird rule. Thank you, Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Symms, I think, was here first.

Senator SYMMS. Well, thank you very much, Mr. Chairman.

I would like to pursue that a little bit further and make one point, Mr. Secretary, that while the debate sometimes focuses on $50,000, there are a lot of Americans with joint incomes, as you pointed out by your illustrations, that are in the $25,000 to $45,000 income groups. If the income level at $29,900 is taxed at rates no higher than 25 percent, but yet the income level at $35,200 would be subject to rates at 37 percent, that's a 50-percent tax increase for earning $6,000 to $7,000 more for a family.

It would appear to me that would be the worst medicine for the economy right now, and it would appear to me that many of these people would be affected that Speaker O'Neill would think would maybe be his constituents. It just appears to me we would be putting a damper on economic recovery, hurting the very people that he is trying to help with this Democrat-planned tax increase.

Am I wrong in saying that there might be a negative impact on people's willingness to start working harder and producing?

Secretary REGAN. Well, obviously, the more you are taxed, the less incentive there is going to be to work.

What we are looking at, Senator, from the point of view of this amount of revenue in the economy at this particular moment, a great deal of this will be spent, obviously. There is a report in U.S. News this week asking people what they would do with their tax cut. It is quite obvious that a majority of them probably will spend it.

But also, of course, these brackets that are going to be hit and capped if this cap were enacted are the people who save the most in the United States. Now, with these huge deficits that we have, we at Treasury are going to find it very difficult not to start crowding out business. We haven't done it yet, but there is an awful lot of capital being raised for business right now; but the more you take out of the savings pool, the less there is going to be left for private business after we get through financing the deficit.

Senator SYMMS. My understanding is that the average savings rate for people who earn above $50,000 is almost twice that of people who earn less than $50,000.

Secretary REGAN. That is correct.

Senator SYMMS. So that amount of money—one way or the other we are going to pay for it. If the Government borrows that money

from the savers in the form of Treasury bills or other Treasury instruments, borrows it from the savings of the people, that is one way of balancing the budget. And the other way of balancing the budget would be just to raise their taxes and take the money in the first place but have the same negative impact on interest rates. Is that what you are saying?

Secretary REGAN. Yes; but I think, of the two, we would rather see the borrowing used now rather than taxes, because of the taking away of the incentive when you start taxing; whereas, if the savings accrual is enlarged it will be a lot more helpful to the private sector.

Senator SYMMS. Well, I quite agree with you. I would just say, Mr. Secretary, then I will yield the rest of my time, I hope that this bill doesn't see the light of day in the Senate. In fact, my hope is that it will be voted down in the House. But I guess we have your assurances and the President's assurances that if for any reason the Congress did pass the bill that it would be vetoed.

Secretary REGAN. That is correct. The President has definitely stated he will veto this bill if it is enacted by the Congress.

Senator SYMMS. That's good. I agree with what Senator Roth said earlier. I know there are 34 of us who have signed the letter who would sustain that veto, and I would hope that we would stay on this course, because in my opinion what we need more than anything now is predictability in the Tax Code, and one of the biggest favors the U.S. Congress could do to the economic recovery would be not to tamper with it in any meaningful fashion now and allow the people who are working the equations for business and industry and investors to at least learn to live within the rules we have now set and not have any major changes in any of the policies. The same thing goes for households and for people who are trying to plan their budgets. Just leave everything alone and let the economic recovery work, if it's really out there, and let it proceed and not tamper with it and continue to keep a furor of unpredictability out there in the American economy, which I think is very detrimental and contributes to high interest rates.

The CHAIRMAN. Senator Long?

Senator LONG. Mr. Secretary, you are suggesting to us that it is our duty to pass a contingency tax. Now I'm just not familiar with a contingency tax. I have been on this committee more than 30 years, and I'm not familiar with contingency taxes. When was the last time we passed a contingency tax?

Secretary REGAN. I doubt if the Congress ever has passed a contingency tax, but these are unique times, Senator, and we are suggesting a unique remedy for a unique time.

Senator LONG. Well, there is no contingency about the deficit—we know we've got it. It seems to me that we ought to either vote a tax and go out and have the courage to tell the American people we voted for it and tell them why we did it, or else we ought to vote against the tax.

I supported the tax cut. I went all the way in supporting the tax cut; I even had some ideas of a few things we could add to it that I thought would make a better deal for the country. But I was counting on the President recommending to us that we hold up on some of the cut if the circumstances didn't justify it.

The advice that I'm getting, even from the best economic advisers that you have in the Council of Economic Advisors, is that we are going to have an enormous deficit even with full recovery.

In my judgment it is a lot easier for us just to hold up on a tax cut that people have not yet had, if it's a tax cut we can't afford, than it is to go forward with more and more tax cuts when at some point we are going to be compelled to vote for a tax increase.

It's my judgment that we can't afford any of the third phase of the tax cut, not just the part for the upper-income people; we can't afford even the part for the lower-income people.

We are faced with a deficit of about $176 billion now. I always add about $42 billion to that, because it usually works out to be about $42 billion more than they told us. So we are faced with a deficit of over $200 billion, and that deficit is projected into the future.

I would be willing to do my duty. I think it is my duty to vote for a tax to try to keep this country solvent and to keep the interest rates down; but your administration ought to be providing the leadership to do something like that.

The budget resolution is asking us to raise $12 billion. That's twice what we are talking about with a $700 cap. If we have got to tax somebody, Mr. Secretary, I don't know why we shouldn't be taxing people like you and me ahead of people whose income is much lower.

That lady in your example who is a nurse, with her husband, could pay $80, but I am looking at a different figure, $3,736—that's what people in my bracket would forgo under the House bill. I admire the Business Rountable—you are a member of that group—but that's what about every member of the Business Roundtable would forgo under that bill, $3,736, since they are in the top bracket.

I talked to members of that organization a while back. I made the point to them—"You don't need that tax cut. You've got a 20-percent capital gains top tax rate now; you've got a top tax rate of 50 percent; you've got accelerated depreciation and a tax credit for investments. You people don't need that additional tax cut."

To the man, Mr. Secretary, the group I was talking to, some of the outstanding members of the Business Roundtable, said that none of them needed it. Insofar as they supported it, it was because they thought maybe somebody else needed it. Maybe the economy needed it, but they did not need it. That's what they told me.

I have been with other business groups, outstanding people, none of whom contend that they need it. Why should we be keeping a big tax cut for people who are making over $200,000 a year and who have already had big tax cuts? They have already had their big cut, you know, when we cut the top rate from 70 down to 50. I voted for that; I even offered the amendment. At the time we did that, it seems to me as we did very well by that group. Why should they have a further tax cut?

Secretary REGAN. Well, what we are saying here, Senator, is that the people above $162,400 would not receive a marginal rate increase. The people that would are those with taxable income from $35,200 up to $162,400. Those are the ones that we are saying that it's not fair to hit them with this tax cap at this point.

Senator LONG. Mr. Secretary, you have got to be looking at the same chart I am looking at. These figures I am sure came from Treasury. People making $300,000 and up, filing joint returns, would forgo the most under the House bill, and it's $3,736.

Now, for the sake of common sense, why should any of us give those people a further tax cut? They've got their capital gains, they've got their accelerated depreciation, they've got their investment tax credits. Why should they have a further tax cut? They have already got the 50-percent limitation on taxing ordinary income.

Secretary REGAN. Well, because of the fact that this is an across-the-board tax cut, trying to make it even for all Americans, and not try to distinguish among them.

You will recall that back in 1981 when we passed the Tax Act it was 20 percent across the board. All we are saying is let's stick with that at this particular moment, don't try to change at this particular time.

You see, we are just coming out of the recession. Our recovery has been underway for two quarters. We want a sustained recovery. We don't want to go back to what happened to us in 1980.

Now, what we are afraid of is that, if you put that cap on this at this point, first of all, in the smaller amounts this will not be spent as a result. There will not be that addition to consumer spending. In the upper brackets it will not be saved; there will not be that addition to savings.

The savings rate as published last Monday indicated we are down to 5.3 percent—back down from 7 percent last July at the time of the second tax cut. We would like to see that go back up again. We think if this tax cut goes through that savings rate will go back up again, and that's what we need.

Senator LONG. My time has expired, Mr. Secretary. Thank you.

The CHAIRMAN. Senator Mitchell?

Senator MITCHELL. Thank you, Mr. Chairman.

Now, Mr. Secretary, you devoted much of your statement to trying to establish that this tax cut will, as you put it, "hit squarely at the middle class in America." As is clear from your earlier remarks, I think your statement is incorrect. In fact, I think I must say that it is highly misleading.

First, you responded to a question by Senator Symms by saying that 88 percent of the effect of this cap would be felt by those making more than $50,000. Isn't that correct?

Secretary REGAN. That is correct.

Senator MITCHELL. That necessarily means that only 12 percent of the effect would be felt by those making less than $50,000; isn't that true?

Secretary REGAN. Of the total dollar amount, of the $6 billion, that's right.

Senator MITCHELL. Now, last year there were 79 million tax returns filed in this country. Nineteen million of them were filed by people making under $10,000. They are not affected by this, are they?

Secretary REGAN. No.

Senator MITCHELL. Twenty-four million of them were filed by people making between $10,000 and $20,000. They are not affected, are they?

Secretary REGAN. No.

Senator MITCHELL. In fact, according to the Joint Tax Committee, this cap kicks in at the bottom level just under $30,000 for an unmarried individual with no dependents; isn't that correct—$29,900?

Secretary REGAN. That's correct. Who does not itemize.

Senator MITCHELL. Right. An adjusted return.

And for that person the difference is one of only $8.00. Is it not?

Secretary REGAN. In 1984, yes.

Senator MITCHELL. Now, therefore, you have between $20,000 and $30,000 nearly 17 million returns; and, except for a very few people right at $29,900, they are not affected, are they?

Secretary REGAN. Right.

Senator MITCHELL. So 60 million American taxpayers who make less than $30,000 a year are unaffected by this cap; isn't that true?

Secretary REGAN. 76 million.

Senator MITCHELL. Now, between $30,000 and $50,000 there are 13 million tax returns filed. Isn't that true?

Secretary REGAN. 14 million.

Senator MITCHELL. And of that 13 million, 3.5 million are affected; isn't that true?

Secretary REGAN. Of the 14 million, 37 million are affected.

Senator MITCHELL. That's according to your own figures right here.

Secretary REGAN. Yes. Right.

Sentor Mitchell. So fewer than a third of the taxpayers making betweeen $30,000 and $50,000 a year are affected. That means that of people who make less than $50,000 a year in this country, 73 million taxpayers, 3.5 million of them are affected. Of those who make over $50,000 a year, 4.75 million of them, they are all affected. And those are from your charts, Mr. Secretary. And for you to sit here and say, on those figures, that this cut hits squarely at the middle class, I say to you is an outrageously misleading statement. It does not hit squarely at the middle class. And of those who are making less than $50,000 a year, they are bearing only 12 percent of the burden imposed by this cap. It hits squarely at those making the upper incomes in our society. That's what it does.

Secretary REGAN. I doubt, Senator, that many people earning $50,000 consider themselves rich. I doubt that many working couples that are going out and trying to buy a house or educate kids at $50,000 or even $60,000 consider themselves rich. They consider themselves the middle class.

Senator MITCHELL. You are quite right, Mr. Secretary, but——

Secretary REGAN. And that's exactly where this is going to hit.

Senator MITCHELL. But the fact of the matter is that 90 percent of the taxpayers make less than $50,000. I know people who make $150,000 a year who don't think they are rich.

Secretary REGAN. That's not my point. My point is that the people who are being affected by this do not consider themselves rich; yet this is postulated by a member of your own party who suggested this as being a tax on the rich. And all I am trying to do

is to clarify the record. This is not a tax on the rich; this is a tax hitting in the middle class.

Senator MITCHELL. Mr. Secretary, you cannot possibly use the phrase middle to describe a group of people who are in the top 10 percent. If they are the middle——

Secretary REGAN. Well then, I suggest you ask them, Senator, what they consider themselves. If you go around and ask a policemen, married to a nurse, 'Are you in the rich class? Are you a wealthy person?' He is not going to say that. He is going to say he is middle class. Ask a chemical engineer married to a secretary what is he. He will tell you he is middle class. This is hitting at the middle class; it's not just for the rich.

Senator MITCHELL. Mr. Secretary, if those who are in the top 10 percent are in the middle class, what are the bottom 90 percent?

Secretary REGAN. They are the workers of America. [Laughter].

Senator MITCHELL. So if the 90 percent are the workers and the 10 percent are the middle class, is there any upper class?

Secretary REGAN. Certainly.

Senator MITCHELL. Is there any higher income?

Secretary REGAN. Certainly; but they are not being affected by this.

Senator MITCHELL. Oh, you are wrong. By your own figures, as Senator Long points out, they are affected.

Secretary REGAN. But it is being postulated by your own party that this is hitting at the wealthy, and it's not. It may be aimed at the wealthy, but it is hitting at these middle class people. I am trying to protect them, these people who will be affected by it. I think they deserve a tax cut—the policeman, the nurse, the chemical engineer deserve a tax cut as much as any other worker in the United States.

Senator MITCHELL. And they have gotten a tax cut.

Secretary REGAN. They have not gotten a tax cut.

Senator MITCHELL. And they are going to get one under this proposal.

Secretary REGAN. Now, that's hyperbole. They have not gotten a tax cut. If you look at the taxes paid by those people in 1980 and in 1983, including social security, there is no tax cut there. The tax cut comes on July 1, if they get it. And that's what I am fighting to preserve.

Senator MITCHELL. I just want to say that I think that for you to suggest that the 10 percent of Americans who are affected by this, most of whom make more than $50,000 a year, represent the middle class in our society is simply a misuse of the English language.

Secretary REGAN. Well, first of all, it's not 10 percent of Americans; it's 10 percent of the taxpayers.

Senator MITCHELL. Of the taxpayers.

Secretary REGAN. That could involve a lot more than 10 percent of Americans, depending on how many children they have.

Senator MITCHELL. When 73 million tax returns are filed with incomes of less than $50,000, and only 3.5 million of those are affected by this, and that 3.5 million bears only 12 percent of the tax cut, and when 4.5 million tax returns are filed with incomes of above $50,000 and they are all affected, and they bear 88 percent of the

burden under this tax cap, then I think it is simply highly misleading to suggest that this hits squarely at the middle class.

Secretary REGAN. What about small business? Do you agree that it hits the small business?

Senator MITCHELL. I am not suggesting it doesn't, and I agree with you that——

Secretary REGAN. And I am saying, what about all the farmers that it hits at? It is hitting at all these types of people. This is not just aimed at the wealthy. That is what I am trying to prove by my testimony here.

Senator MITCHELL. Well, your words say one thing; the facts say another.

Secretary REGAN. I doubt that.

Senator MITCHELL. I'm sorry, Mr. Chairman, my time is up.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. Thank you very much, Mr. Chairman.

Mr. Secretary, in listening to you talk about how this is bad economic policy and how this would really hit at the middle class, I think that the testimony that you gave today and the testimony given yesterday by your administration were very much in conflict.

As I understand your statement, those under $29,000 would not be affected insofar as the $700 cap. But as I look at the charts that were presented yesterday, on the increase in tax as proposed by your administration on health insurance premiums, on those making from $20,000 to $30,000 it is a $213 tax increase a year. On those making from $30,000 to $50,000, it is a $282 tax increase.

Why is it all right to increase the tax there and not reduce the tax cut on these same people, where they would not be affected with a cap placed on it? I don't understand that reasoning. I don't understand why taking it out of the pockets of those people with this tax on health insurance premiums doesn't have the same kind of effect on the economy, and certainly it hits at this group of people with a much lower income than does the cap propose.

Secretary REGAN. Well, first of all, you understand, Senator, that if both of these, our cap proposal for medical expenses were enacted and also this $700 cap, that would be a double dip. These people would be hit twice—once for medical and the other by not getting the tax cuts that they originally would get.

Senator BENTSEN. These people under $29,000 would not be hit at all under the tax cap. So let's talk about that particular group that would be hit here by $213 each.

Secretary REGAN. Well, you realize that there is another reason here, that the majority of people will not be affected by the medical cap that we are putting on employers for their employees. We have got to do something about medical costs in this country; I think you will agree with that.

Senator BENTSEN. Do you agree with these charts that say that they will be hit from the $20,000 to the $30,000 income level? This is your administration's chart, that says they will be hit by $213 in increased taxes.

Secretary REGAN. Yes, but I don't have a copy of those charts with me this morning, Senator, so I'm unable to give you the figures; but I think you could read from there the number of people

that are affected by that, in that income group. I think it is a very small proportion of people in that income group that are affected.

Senator BENTSEN. As I understand it, it is a very large proportion. But let's get to another point, the question of fairness.

We have had a cut in taxes for those over $50,000, and in particular by the reduction of 70 to 50 percent. And I supported that.

We had dividend reinvestment put in; we had two-earner marital deduction; we had the net interest exclusion; we had the all-savers certificates; we had the incentive stock options; we had a reduction in the maximum capital gain from 28 to 20 percent; we increased the Keogh limit from $7,500 to $15,000. Now, if you don't have the figure now, I would like to have the figure given to us for the record on what percentage of that tax benefit went to individuals over $50,000.

Now, at the same time that was done, last year we put in a 5 cent gasoline tax; we increased the payroll tax, and that in particular hit the lower and middle-income taxpayer.

What we are seeking to do now is to try to find some way to equalize the burden and at the same time cut back on this deficit.

Let me give you another assumption that was made when the tax cut was passed. As I recall, the assumption was that we were going to have about a 24-percent inflation rate over those 3 years.

Now, because of the monetary policies of Mr. Volcker, the fact that OPEC has lost control of the price of oil and it's come down, and the fact that you have seen a depression on the farms which is holding down the price of food, we see inflation has increased at about 17 percent over the 3-years projections.

Now, if you put that into the equation, you are looking at a tax cut that equates to about 32 percent. So I think that we should adjust to changing conditions. When you have a $200 billion deficit, you ought to take into consideration those things that have transpired since that tax cut was passed.

And things have happened that were not anticipated: inflation was reduced further than we had anticipated, but tax increases have been passed on those with low- and middle-incomes in particular.

Balance is what we are trying to achieve. If we don't get it at $700, maybe it ought to be $1,000. The Joint Tax Committee says that would level out at about the $50,000 level, and that would bring you $4 billion a year that we could utilize to cut that deficit.

I would like your consideration and comments on that.

Secretary REGAN. Well, first of all, we will submit those figures for the record.

[The figures follow:]

August 2, 1983

As shown on the following table, capping the third phase of the cut at $1,145 would increase taxes for 1.8 million returns, 94 percent of which have incomes over $50,000. This cap would result in a $2.2 billion increase in fiscal year 1984 receipts rising to $3.4 billion by fiscal year 1988.

Office of the Secretary of the Treasury
Office of Tax Analysis

26-294 O—83——7

Change in 1984 Tax Liability Due to Limiting the Third Phase
of the Across-the-board Rate Reductions to $1,145

(1984 Law, 1982 Levels of Income)

Adjusted gross income	Number of returns	1984 law tax liability		Limit the third phase of the Act to $1,145					
				Change in tax liability			Returns with tax increase		
		Amount	Percentage distribution	Amount	Percentage change	Average change	Number	Percent of returns with tax increase	Percent of all returns
($000	(thous.)	($ mil.)	(percent)	($mil.)	(percent)	(dollar)	(thou.)	(.... percent .....)	
Less than 30	75,680	$81,217	33.3%	--	--	--	--	--	--
30 - 50	14,288	72,645	29.8	$ 12	*	$ 109	111	6.1%	0.8%
50 and over	4,531	89,839	36.9	1,873	2.1%	1,090	1,718	93.9	37.9
Total	94,500	$243,702	100.0%	$1,885	0.8%	$1,031	1,829	100.0%	1.9%

Office of the Secretary of the Treasury
Office of Tax Analysis

August 2, 1983

Note: Details may not add to totals due to rounding.

*Less than .05 percent.

Secretary REGAN. I have two quick comments on your statement.

We agree with you that the deficits are too high and they should not be allowed to run at the $2-billion level next year as they will this year; but we think the proper way to go about that is to attack through spending.

We notice, for example, in the budget resolution, of the things that are reconciled or call for reconciliation, only $12 million over the 3-year period are for spending reductions, and $73 billion are for the tax increases. That hardly seems to us, in reconciliation, to be the proper proportion. We think that there should be a lot more spending cuts that should be reconciled—perhaps, as we tried it with the so-called gang of 17 back in 1982, to reach a three-for-one basis, $3 for spending cuts for $1 of tax increases. That seems to us to be a much better proportion of the way to do things.

As far as the justification for having the tax cut now, this has been part of tax planning. It is based in the law. As I said before in answer to questions, we are coming out of the recession; we need more savings. We don't think that the proper way to achieve more savings would be at this point to start taxing more, no matter what the bracket would be, because it is bound to affect the savings rate in the United States.

Senator BENTSEN. My concern, Mr. Secretary, is whether we cut as much as we had planned to cut 3 years ago, with the major changes that we have seen in our economy and the kind of deficit we face.

The CHAIRMAN. Senator Durenberger?

Senator DURENBERGER. Mr. Secretary, let me take you to pages 2 and 3 of your testimony and quote something under the heading "Contingency Tax Plan":

"It is because of the problems associated with substantial long-term deficits that we continue to suggest a contingency tax plan for fiscal years 1986-1988."

On the next page, part of the plan is described as follows:

"However, we cannot have enactment of the contingency tax plan until Congress first adopts spending cuts such as the President has proposed."

My first question is, What is the tax side of the contingency plan as of today? And related to that is the question as to whether or not the budget resolution proposed to us conforms with that plan.

Secretary REGAN. We have not changed our minds since the President's original proposal in his budget to the Congress; and that is, if spending cuts are enacted, we would ask the Congress later this year to enact tax increases that would go into effect in 1985. The reason for doing it now rather than waiting until 1985 is simply to reassure the financial markets and others who are worried about how we are going to finance those deficits that we will come to grips with the problem in 1985, when we are well on the road to a recovery and the recovery has had a couple of years of being in place.

Now, we have said, however, that unless the Congress is willing to make the spending cuts, we don't want to see taxes increased—the reason for that being that the tax increases only go to account for the additional spending rather than to cut the deficit. And that's what we are trying to accomplish.

Senator DURENBERGER. The second part of my question was—and that's a rephrasing of what you said here—we have a budget resolution reported out of a conference committee that we will be voting on, and I want to know whether or not the tax side, the dollars involved, for example, conform with the dollars——

Secretary REGAN. They do not conform with what we have suggested. We have not suggested $12 billion in 1984, nor have we suggested $15 billion in 1985. They conform reasonably well to the amounts we have suggested for fiscal 1986.

Senator DURENBERGER. And on the spending side, does the budget resolution or the conference report conform with the spending criteria set up?

Secretary REGAN. Well, I am not that much of an authority on the spending side of the budget; but from what I gather, from reports that have been furnished to me, the total spending is above what the President has suggested. In addition to which, there is another $9 or $10 billion of contingency that is set aside to be enacted perhaps later. So the net result would be that the spending is above what the President would want.

Senator DURENBERGER. As far as the $73 billion, if the budget resolution were adopted, what is the administration's recommendation on where to raise this money?

Secretary REGAN. I don't know. We would have to wait to see what the Congress would want to do. It would be a congressional problem.

Senator DURENBERGER. Well, we are talking about a variety of ways of doing it—one of them is the tax cap. Are you still on the surcharge, the energy tax? Where is the administration on how to raise big money?

Secretary REGAN. Well, that is what we are suggesting for 1985. We have no suggestions for $12 billion for 1984, and no suggestions for $15 billion for 1985, fiscal.

Senator DURENBERGER. So if that conference report is adopted, then we are on our own to try to raise $12 billion, and we can raise it in any way we please?

Secretary REGAN. We would be very glad to offer you professional help in this area, but no policy guidance.

Senator DURENBERGER. And with regard to the $46 billion that we have to make decisions on this year to take effect in the later years?

Secretary REGAN. Our guidance on that would be that we would consider a surcharge and an oil tax for 1985.

Senator DURENBERGER. What would the surcharge be on?

Secretary REGAN. A surcharge on individual income taxes and business taxes.

Senator DURENBERGER. Corporate income tax?

Secretary REGAN. Yes.

The CHAIRMAN. You probably would consider some other things, too—right?

Secretary REGAN. Well, we would be glad to consider them with this committee, obviously. I am not suggesting that we would go along with them, but we would be glad to consider them.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Mr. Secretary, I have a few points. One is that I generally echo the points made by Senators Mitchell and Bradley and Bentsen on this whole issue. I think the points they have brought out should be borne in mind not only by the administration but by everyone else who is interested in this issue.

My question, though, is to another point entirely: Since the administration is in favor of reductions and is opposed to any repeals of reductions in income taxes, particularly the $700 cap, does that mean that the administration is also opposed to Congressman Rostenkowski's proposal to freeze scheduled reductions in place, particularly the scheduled increases in the unified Federal estate and gift tax amounts as well as the scheduled reductions in the federal estate tax rates?

Secretary REGAN. Yes. That is correct, Senator.

Senator BAUCUS. That is the administration's position?

Secretary REGAN. We would oppose that.

Senator BAUCUS. All right. Thank you very much.

The CHAIRMAN. Are you finished?

Senator BAUCUS. Yes.

The CHAIRMAN. Are there other questions?

Senator BENTSEN. I would like to make one comment.

The CHAIRMAN. Sure.

Senator BENTSEN. There has been a great deal of comment on where middle income ends and high income starts. I might add one more comment to it, the comment that the President made last week, as I understand it, when he said:

> You know, for many years the liberals have looked at a $50,000 income as being the dividing line between the middle class and the rich. It's time that we made some adjustment for inflation. I wonder if Speaker O'Neill realizes that the $50,000 of 1973 is $113,183 in 1983?

The President apparently feels that that might be a more appropriate dividing line.

Thank you.

The CHAIRMAN. Mr. Secretary, I think you may have detected is a slight tinge of politics in all of this. [Laughter.]

And I don't quarrel with my friends on the other side, because this is a matter of concern. I assume it will come to us. I assume Speaker O'Neill has the votes, and it will come to us tomorrow or next week. Then we will try to dispose of it in some way. Do you have any preference? [Laughter.]

Secretary REGAN. I would say in the understatement of the day, Senator, I hope that the bill would be defeated on the floor of the Senate.

The CHAIRMAN. Right. Well, I think there is a strong possibility of that.

I don't have any questions. I just wanted you to have an opportunity, and I know some of my Democratic colleagues wanted an opportunity to make their point, and I think they made some points; but it seems to me we could all join together here one of these days and look at some areas where we ought to be going after some of these so-called upper income. We have just tried to eliminate the sunset on mortgage revenue bonds, which to me is pretty much targeted to upper income individuals, and there are a number of other

areas that we should address. We have just lost a bundle of revenue on withholding, or are about to.

So it is my hope that we can look at compliance. We start a hearing on compliance in a couple of minutes. There is still a hundred billion out there we are not collecting each year.

We are also in the process of reviewing preferences in the code.

So hopefully we could all agree—Democrats and Republicans, and the administration—if we have to come up with revenues, that there are places to do it without trying to go back and increase the marginal rates. That's why I hope the administration has an open mind on a lot of things.

Secretary REGAN. Well, Senator, we are more than willing to work with you on this; without committing the administration in advance to any particular item, we are willing to give you such professional help as we can as well as make appearances before your committee on specific issues, if you so desire.

The CHAIRMAN. All right.

Well, thank you very much, and we appreciate your coming before the committee.

Secretary REGAN. Thank you for the opportunity to present our views.

Thank you, gentlemen.

The CHAIRMAN. We will have a 2-minute recess.

[Whereupon, at 11:15 a.m., the hearing was recessed.]

AFTER RECESS

The CHAIRMAN. I think we are going to reduce some of the glare here, if it's all right. We are getting into serious business here on tax compliance, and we know it doesn't have nearly the interest as the third year of the tax cut.

Senator BENTSEN. Excuse me, Mr. Chairman, not nearly the politics.

The CHAIRMAN. Well, that my be true, yes.

But we understand IRS is going to release some preliminary information on compliance, and we had some success last year in improving compliance, so we would hope that if in fact there are going to be, as I indicated to Secretary Regan, a lot of effort to raise revenue, we first ought to look on the compliance side and look at some of the tax preferences.

So I think, in an effort to expedite the hearing, if we can have the first panel. It will be Phillip E. Coates, Acting Commissioner, Internal Revenue Service. Please extend our best wishes to Mr. Egger, who I understand is recovering and is in good shape.

Commissioner COATES. I certainly will, Senator.

The CHAIRMAN. Buck Chapoton is here on a daily basis. And Mr. Henry, I guess you are in the next group. You are separate.

So we will hear from Mr. Coates and Mr. Chapoton.

Again, if you can summarize the highlights of your statements, they will be made a part of the record.

STATEMENT OF HON. PHILIP E. COATES, ACTING COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, D.C.

Commissioner COATES. Thank you, Mr. Chairman.

I am pleased to be with you today to discuss the Service's latest efforts to estimate the size, scope, and composition of the tax gap.

I will attempt to summarize my statement and ask that the complete statement be printed for the record. In my testimony I will focus on a definition of the tax gap, an overview of the tax gap in total, and highlights of selected components of the tax gap. I have attached to this statement an appendix which provides details of our estimates.

Commissioner Egger, as you may know, is still recovering from his surgery and has not yet returned to his duties. Deputy Commissioner Owens is out of the country this week representing the Service at an International Tax Conference. I am now the Acting Commissioner, but normally serve as the Associate Commissioner for Policy and Management. In that capacity I oversee the efforts of the Research Division, which is primarily responsible for the estimates I will be discussing.

Other Service officials are here as well, and will be available to assist me in replying to any questions you or the members may have at the conclusion of my testimony. I have on my immediate right Mr. Dennis Cox, who is the chief of the Compliance Estimates Group from the Research Division.

First a note about the estimates. I cannot emphasize too strongly that the figures I will discuss shortly are estimates and/or projections. They were prepared in IRS and are based principally on original research conducted or sponsored by IRS. While they are the best estimates we can make with the information available at this time, there is some uncertainty associated with them. This uncertainty is greater than for ordinary economic estimates for a number of reasons, such as the self-interest of persons who are practicing tax evasion in concealing the facts. Furthermore, our legal sector estimates for 1979 and 1981 are projected from earlier years.

In March of 1982, Commissioner Egger testified before the Oversight Subcommittee concerning the tax gap. He presented preliminary estimates for 1973 to 1981, stressing that the estimates were subject to revision. The estimates I will present today cover the same time period, but are somewhat lower due to a number of revisions resulting from additional research. To the extent that these estimates deal with unreported incomes of individuals, they also may be considered updates of similar figures provided in our 1979 report, "Estimates of Income Unreported on Individual Income Tax Returns." However, these estimates do much more than simply extend the estimates contained in that report. The present estimates are based on substantially revised concepts and improved estimating methods. In addition, our coverage now goes beyond unreported income which was the focus of the 1979 report.

From a tax administration standpoint, trends in noncompliance with the tax law are at least as significant as the specific amounts and patterns of noncompliance existing at any given time. While the amounts of noncompliance are important because extreme values can point to problem areas tax administrators and policymakers need to address, trends indicating a decline in compliance over time are also important because they provide early warning signals of possible future problem areas. We believe that the trends

implied by these estimates indicate with a fair degree of accuracy the extent to which taxpayers are voluntarily continuing to meet their obligations.

DEFINITION OF THE GAP

We define tax gap as the difference between the total amount of income tax which is voluntarily paid for a given tax year and the correct tax liability for that year.

This oversimplified definition requires some elaboration. First, the definition is concerned with income taxes only. While there are problems of compliance with respect to employment tax, excise taxes, et cetera, they were not the focus of these estimates. Next, the word voluntarily means without actual enforcement action, such as collection, examination, or criminal investigation. The definition also refers to the tax year. Since almost all individual taxpayers and most corporate taxpayers use calendar years for their tax years, the tax gap estimates cannot be directly related to Federal budget figures, because the Government's accounting year ends September 30.

Our estimates are divided into two parts—the legal and the illegal sectors. "Legal sector" earnings include incomes from regularly established enterprises or occupations and from legal activities that are sometimes called irregular because they take place in informal settings. Examples of these unreported legal sector earnings are unreported interest and dividends, unreported tips, and unreported earnings of independent contractors and other individuals.

The legal sector may be divided into four components: Income tax due from individuals who filed returns; income tax from individuals who failed to file returns; income tax due from corporations which filed returns; and income tax due from corporations which failed to file returns.

By far, the largest part of the estimate of taxes due relates to individual taxpayers who do file returns. The estimating method for this category requires separate accounting for several types of noncompliance: arithmetic errors on filed returns, unreported income: overstated business expenses; overstated exemptions, deductions, and statutory adjustments; and failure to pay reported liability.

Illegal sector incomes are those derived from organizing, financing, producing and delivering illegal goods or services related to drugs, gambling, prostitution, and so on.

I should point out that our estimates of the total tax gap do not include any category labeled underground economy. This is so because the amounts of unreported income in the tax gap estimates do not necessarily correspond to any concepts commonly associated with this broad term. For example, individuals who fail to report interest income received from banks contribute to the tax gap, but the income is not underground. Also, while illegal-source income and moonlighting (or off-the-books income) are part of the underground economy as the term is commonly understood, some fraction of this income is voluntarily reported to the IRS. Another fraction is not even required to be reported, as the incomes of many

participants in the underground economy are so low that filing is not required.

AN OVERVIEW OF THE TAX GAP

As shown in appendix 1 attached to my statement, the legal sector tax gap for individuals, corporations, and others, has grown from $28.8 billion to $81.5 billion during the period 1973 to 1981. Individuals are estimated to account for $75.3 billion of the gap in 1981, or approximately 92 percent, because of both a higher volume of tax receipts from individuals—about 75 percent of all receipts—and a somewhat lower level of tax compliance—bout 80 percent for individuals versus 90 percent for corporations. Corporations (including fiduciaries and unrelated business income tax of exempt organizations) accounted for the remaining 8 percent of the gap, or $6.2 billion. Individuals who filed returns, and who either overstated deductions or underreported income, understated their tax liabilities by nearly $66 billion. Individual filers failing to remit taxes due accounted for another $4.4 billion of the tax gap. Nonfilers of individual income tax returns accounted for about $3 billion of the 1981 tax gap. By far the largest component of the tax gap, more than $50 billion, resulted from taxpayers failing to report their full income.

Estimates of the income tax gap associated with certain major illegal activities have grown from $2.1 billion in 1973 to $9 billion in 1981. Approximately 65 percent of this gap is related to unreported income from drug trafficking.

Legal sector estimates in their raw form appear to be rising rapidly. Appendix 2 shows that unreported income, for example, rose from $93.9 billion in 1973 to $249.7 billion in 1981, an increase of over 166 percent in 8 years. In a period of often double-digit inflation such as 1973 to 1981, however, current dollar measures of noncompliance would also be expected to show rapid increases. To be able to discern the underlying real compliance trends hidden in the raw data, these measures were recast in terms of voluntary reporting percentages [VRP's] which are percentages relating sums voluntarily reported to sums that should have been reported.

The percentage of all income voluntarily reported by individuals declined from 91.2 percent in 1973 to 89.3 percent in 1981, as shown in appendix 3. On the average, then, compliance in total income reporting declined at a rate of about two-tenths of a percentage point each year over this period. Given the size of the economy, however, this rate of decline is not insignificant. Both the level and the trend of total income reporting compliance are dominated by wage and salary income, and it is by far the largest component of reportable income—about two-thirds of total income in 1981. The rate of decline in this area is less than the overall rate of decline. This reflects the effectiveness of withholding in generating voluntary compliance.

Despite the magnitude of the problem, I can't emphasize too strongly that most taxpayers are conscientious, and that the tax system is basically sound and reliable. The tax reported voluntarily—that is, without any enforcement effort—is approximately 80 percent of what is owed. We should not overlook, however, the fact

that this voluntary compliance results largely from a good set of tax administration rules based on withholding and information reporting, and a tradition of effective and fair tax administration.

TAX GAP ESTIMATES FOR INDIVIDUALS IN THE LEGAL SECTOR

Let me briefly describe the estimates for the tax gap, unreported income, and overstated items associated with legal-source income earned by individuals. Appendix 4 displays estimates for 1981 of various types of filer and nonfiler noncompliance. Note that the tax gap for nonfilers is much smaller than for filers, even though the unreported income figures for the two groups are roughly comparable. There are three reasons for this: First, not all unreported income of nonfilers is taxable, because if nonfilers did file, they could offset some of their income with exemptions, deductions, and credits. Second, unreported nonfiler incomes would be taxed at lower marginal rates than would unreported filer incomes. This difference occurs because the unreported income of filers would be added to the amounts which they are already voluntarily reporting. Third, the nonfiler tax gap is reduced by estimates of withholding on nonfiler wages, which accounts for about 65 percent of nonfiler incomes.

TAX GAP ESTIMATES FOR CORPORATIONS, FIDUCIARIES, AND BUSINESS INCOME TAXES OF EXEMPT ORGANIZATIONS

The estimated tax gap for corporations displays an upward trend between 1973 and 1979, increasing from $3.5 billion in 1973 to $6.2 billion in 1979, before decreasing to $6 billion in 1981, as shown on appendix item 5. The increase in the gap is due primarily to the increase in tax liability for large corporations between 1973 and 1979, about 70 percent. The decline between 1979 and 1981 is due to a decrease in corporate profits and an decrease in corporate taxes resulting from an increase in depreciation allowances since 1979. The number of returns of active corporations filed for 1973 and 1981 were 1.9 million and a projected 2.8 million, respectively, giving an average tax gap per return for these 2 years of about $1,800 and $2,100.

As an adjunct to these figures, we have also estimated the number of delinquent corporation returns and their related tax due. For 1981, we estimate 84,000 delinquent corporate tax returns (out of some 2.8 million filed) with tax due of some $15 million. On balance, this does not appear to be a major problem area.

PARTIAL TAX GAP ESTIMATES FOR THE ILLEGAL SECTOR

The measurement of illegal activities is difficult because it requires quantification of activities that, to a large extent, must be deliberately concealed if they are to take place at all. At best, therefore, the estimation of unreported illegal incomes can be only partially successful. For this reason, we have kept the analysis of incomes generated in illegal transactions separate from the analysis of unreported legal-source incomes.

The extraordinary difficulties encountered in estimating tax gaps associated with the illegal sector make it necessary to limit the cat-

egories of illegal activities for which estimates are attempted. For this reason, estimates of unreported income and tax gap were prepared for only three classes of illegal activities: illegal drugs, gambling, and prostitution, the three categories included in the previous IRS report on noncompliance.

The CHAIRMAN. Could you just sort of summarize the last three pages there? We want to get into how to close the gaps. We know there are gaps; we are trying to figure out how to close them.

Commissioner COATES. I would be happy to do it. I think I pretty much have covered the important points, Senator, of the tax gap in all the areas that were enumerated in the report. So I think we can pretty much say that——

The CHAIRMAN. Right. And as I understand, Secretary Chapoton, then, will give us the policy on how to close these. Is that right?

Commissioner COATES. Right.

I would like to point out, if I may, Senator, that the supporting detail for the figures we have given you today, and the report, are going to be available to whomever would like to have a copy in a short period of time, and the address that these requests should be addressed to is contained in my full statement.

The CHAIRMAN. Thank you. We may have some questions, but I think if we can hear from Secretary Chapoton, maybe he can close the gaps for us.

Secretary REGAN. Fine.

[The prepared statement of Philip E. Coates follows:]

STATEMENT OF PHILIP E. COATES ACTING COMMISSIONER OF INTERNAL REVENUE

Mr. Chairman and members of the committee: I am pleased to be with you today to discuss the Service's latest efforts to estimate the size, scope, and composition of the "tax gap."

In my testimony, I will focus on a definition of the tax gap, an overview of the tax gap in total, and highlights of selected components of the tax gap. I have attached to this statement an appendix which provides details of our estimates.

Commissioner Egger, as you may know, is still recovering from his surgery, and has not yet returned to his duties. Deputy Commissioner Owens is representing the Service at an important international conference this week. I am now the Acting Commissioner, but normally serve as the Associate Commissioner for Policy and Management; in that capacity, I oversee the efforts of the Research Division, which is primarily responsible for the estimates I will be discussing.

Other Service officials are here today as well, and will be available to assist me in replying to any questions you or the Members may have at the conclusion of my testimony.

A NOTE ABOUT THE ESTIMATES

I cannot emphasize too strongly that the figures I will discuss shortly are estimates and/or projections. They were prepared in IRS and are based principally on original research conducted or sponsored by IRS. While they are the best estimates that we can make with the information available at this time, there is some uncertainty associated with them. This uncertainty is greater than for ordinary economic estimates for a number of reasons, such as the self-interest of persons who are practicing tax evasion in concealing the facts. Furthermore, our legal sector estimates for 1979 and 1981 are projected from earlier years.

In March 1982, Commissioner Eggar testified before the Oversight Subcommittee concerning the tax gap. He presented preliminary estimates for 1973–81, stressing that the estimates were subject to revision. The estimates I will present today cover the same time period, but are somewhat lower due to a number of revisions resulting from additional research. To the extent that these estimates deal with unreported incomes of individuals, they also may be considered updates of similar figures provided in our 1979 report. *"Estimates of Income Unreported on Individual Income Tax Returns."* However, these estimates do much more than simply extend the esti-

mates contained in that report. The present estimates are based on substantially revised concepts and improved estimating methods. In addition, our coverage now goes beyond unreported income which was the focus of the 1979 report.

From a tax administration standpoint, trends in noncompliance with the tax law are at least as significant as the specific amounts and patterns of noncompliance existing at any given time. While the amounts of noncompliance are important because extreme values can point to problem areas tax administrators and policy makers need to address, trends indicating a decline in compliance over time are also important because they provide early warning signals of possible future problem areas. We belive that the trends implies by these estimates indicate with a fair degree of accuracy the extent to which taxpayers are voluntarily continuing to meet their tax obligations.

DEFINITION OF THE TAX GAP

We define "tax gap" as the difference between the total amount of income tax which is voluntarily paid for a given tax year and the correct liability for that year.

This oversimplified definition requires some elaboration. First, the definition is concerned with income taxes only. While there are problems of compliance with respect to employment taxes, excise taxes, etc., they were not the focus of these estimates. Next, the word "voluntarily" means without actual enforcement action, for example, collection, examination, or criminal investigation. The definition also refers to the "tax year." Since almost all individual taxpayers and most corporate taxpayers use calendar years for their tax years, the tax gap estimates cannot be directly related to Federal budget figures, because of Government's accounting year ends September 30.

Our estimates are divided into two parts—the legal and illegal sectors. "Legal sector" earnings include incomes from regularly established enterprises or occupations, and from legal activities that are sometimes called irregular because they take place in informal settings. Examples of these legal earnings are unreported interest and dividends, unreported tips, and unreported earnings of independent contractors and other individuals.

The legal sector may be divided into four major components:

Income tax due from individuals who filed returns;

Income tax due from individuals who failed to file returns;

Income tax due from corporations which filed returns; and

Income tax due from corporations which failed to file returns.

By far, the largest part of the estimate of taxes due relates to individual taxpayers who do file returns. The estimating method for this category requires separate accounting for several types of noncompliance: arithmetic "errors" on filed returns; unreported income; overstated business expenses; overstated exemptions, deductions, and statutory adjustments; and failure to pay reported tax liability.

"Illegal sector" incomes are those derived from organizing, financing, producing, and delivering illegal goods or services related to drugs, gambling, prostitution, and so on.

There is no absolute correlation between illegal-source income and income tax nonreporting, because criminals who want to reduce their exposure to prosecution sometimes do report at least a portion of their illegal-source income in laundered form on their tax returns.

We have estimates for three categories of illegal-source income: drug trafficking, illegal gambling, and prostitution. As you might expect, the estimates for illegal-source income are incomplete, because no source of information is available to support estimates of total income from crime. These estimates must be built up from data for various types of crime, and developing them is a long-range research effort.

I should point out that our estimates of the total tax gap do not include any category labeled "undergound economy." This is so because the amounts of unreported income in the tax gap estimates do not necessarily correspond to any concepts commonly associated with the broad term. For example, individuals who fail to report interest income received from banks contribute to the tax gap, but the income is not "underground." Also, while illegal-source income and moonlighting (or "off the books" income) are part of the underground economy as the term is commonly understood, some fraction of this income is voluntarily reported to IRS. Another fraction is not even required to be reported, as the incomes of many participants in the "underground economy" are so low that filing is not required.

OVERVIEW OF THE TAX GAP

As shown in appendix item 1 to this statement, the legal sector tax gap for individuals, corporations, and others has grown from $28.8 billion to $81.5 billion during the period 1973 to 1981. Individuals are estimated to account for $75.3 billion of the gap in 1981, or approximately 92 percent, because of both a higher volume of tax receipts from individuals (approximately 75 percent of all receipts) and a somewhat lower level of tax compliance (about 80 percent for individuals versus 90 percent for corporations). Corporations (including fiduciaries and unrelated business income tax of exempt organizations) accounted for the remaining 8 percent of the gap, or $6.2 billion. Individuals who filed returns, and who either overstated deductions or underreported income, understated their tax liabilities by nearly $66 billion. Individual filers failing to remit taxes due accounted for another $4.4 billion of tax gap. Nonfilers of individual income tax returns accounted for about $3 billion of the 1981 tax gap. By far the largest component of tax gap, more than $50 billion, resulted from taxpayers failing to report their full income.

Estimates of the income tax gap associated with certain major illegal activities (drugs, gambling, and prostitution) have grown from $2.1 billion in 1973 to $9.0 billion in 1981. Approximately 65 percent of this gap is related to unreported income from drug trafficking.

Legal sector estimates in their raw form appear to be rising rapidly. Appendix item 2 shows that unreported income, for example, rose from $93.9 billion in 1973 to $249.7 billion in 1981, an increase of 166 percent in 8 years. In a period of often double-digit inflation such as 1973–81, however, current-dollar measures of noncompliance would be expected to show rapid increases. To be able to discern the underlying real compliance trends hidden in the raw data, these measures were recast in terms of voluntary reporting percentages [VRP's], which are percentages relating sums voluntarily reported to sums that should have been reported.

The percentage of all income voluntarily reported by individuals declined from 91.2 percent in 1973 to 89.3 percent in 1981 (Appendix item 3). On the average, then, compliance in total income reporting declined at a rate of about two-tenths of a percentage point each year over this period. Given the size of the U.S. economy, however, this rate of decline is not insignificant. Both the level and the trend of total income reporting compliance are dominated by wage and salary income, as it is by far the largest component of total income (about two-thirds of reportable income in 1981). The rate of decline in this area is less than the overall rate of decline. This reflects the effectiveness of withholding in generating voluntary compliance.

Despite the magnitude of the problem, I can't emphasize too strongly that most taxayers are conscientious, and that the tax system is basically sound and reliable. The tax reported voluntarily—that is, without any enforcement effort—is approximately 80 percent of what is owed. We should not overlook, however, the fact that this voluntary compliance results largely from a good set of tax administration rules based on withholding and information reporting, and a tradition of effective and fair tax administration.

TAX GAP ESTIMATES FOR INDIVIDUALS IN THE LEGAL SECTOR

Let me briefly describe the estimates for tax gap, unreported income, and overstated items associated with legal-source income earned by individuals. Appendix item 4 displays estimates for 1981 of various types of filer and nonfiler noncompliance. Note that the tax gap for nonfilers is much smaller than for filers, even though the unreported income figures for the two groups are roughly comparable. There are three reasons for this: First, not all unreported income of nonfilers is taxable, because if nonfilers did file, they could offset some of their income with various exemptions, deductions, and credits. Second, unreported nonfiler incomes would be taxed at lower marginal rates than would unreported filer income. This difference occurs because the unreported incomes of filers would be added to the amounts which they already voluntarily reported. Third, the nonfiler tax gap is reduced by estimates of withholding on nonfiler wages, which account for about 65 percent of nonfiler incomes.

The mix of types of unreported income is somewhat different for filers and nonfilers. For filers, unreported wage income is about 14 percent of total unreported income; in the case of nonfilers, wages account for about 65 percent. Business income (farm, nonfarm, partnership, informal supplier, and small business corporation income) accounts for approximately 50 percent of filer unreported income, but less than 16 percent of nonfiler income. Dividends and interest together account for 14 percent of filer and 9 percent of nonfiler unreported income.

TAX GAP ESTIMATES FOR CORPORATIONS, FIDUCIARIES, AND BUSINESS INCOME TAXES OF EXEMPT ORGANIZATIONS

The estimated tax gap for corporations displays an upward trend between 1973 and 1979, increasing from $3.5 billion in 1973 to $6.2 billion in 1979, before decreasing to $6.0 billion in 1981 (appendix item 5). The increase in the gap is due primarily to the increase in tax liability for large corporations between 1973 and 1979 (about 70 percent). The decline between 1979 and 1981 is due to a decrease in corporate profits and a decrease in corporate taxes resulting from an increase in depreciation allowances since 1979. The number of returns of active corporations filed for 1973 and 1981 were 1.9 million and a projected 2.8 million, respectively, giving an average tax gap per return for these 2 years of $1,820 and $2,137.

As an adjunct to these figures, we have also estimated the number of delinquent corporation tax returns and the related tax due. For 1981, we estimate 84,000 delinquent corporate tax returns (out of some 2.8 million filed), with tax due of some $15 million. On balance, this does not appear to be a major problem area.

The tax gap estimate for fiduciaries (such as estates and trusts) is based on our Taxpayer Compliance Measurement Program [TCMP] survey data. However, there has been only one TCMP survey of fiduciaries to date, in 1975. That survey showed a gap between the amount of tax reported and the tax that should have been reported of about $41 million, which was 4.8 percent of the correct liability. This 1975 TCMP-based tax gap figure was extrapolated to 1973, 1976, 1979, and 1981 on the assumption that liability grew at the same rate as fiscal year receipts, which are available for each year. Given this rate of nonreporting and the growth in tax liability, the estimated tax gap for 1981 is $108 million.

A separate study of returns filed by certain tax-exempt organizations (excluding churches) with business income showed a total of $24 million of unrelated business income tax liability for these organizations, of which only $5 million (or 21 percent) was voluntarily reported. A small number of public charities accounted for 90 percent of the total $19 million of underreported tax on these returns. Our estimates of unreported unrelated business income taxes for all tax exempt organizations (including churches) for all years are based on the results of this study. Reported tax was assumed to be only 21 percent of the tax that should have been paid, and the resulting tax gap amounts are shown in Appendix item 5. Other years were estimated on the assumption that liability grew at the same rate as fiscal year receipts, which are available for each year.

PARTIAL TAX GAP ESTIMATES FOR THE ILLEGAL SECTOR

The measurement of illegal activities is difficult because it requires quantification of activities that, to a large extent, must be deliberately concealed if they are to take place at all. At best, therefore, the estimation of unreported illegal incomes can be only partially successful. For this reason, we have kept the analysis of incomes generated in illegal transactions separate from the analysis of unreported legal-source incomes.

There is, however, an additional reason not to mix unreported incomes and taxes associated with the illegal sector with those in the legal sector. Although, according to U.S. law, all illegal-source incomes are taxable, as a practical matter such taxes are not likely to be collectable to nearly the same extent as taxes on legal-source incomes. Thus, even if unreported illegal-source incomes could be estimated with a reasonable degree of accuracy, from a tax administration standpoint such estimates would have fundamentally different fiscal and policy implications and require separate evaluations.

The extraordinary difficulties encountered in estimating tax gaps associated with the illegal sector make it necessary to limit the categories of illegal activities for which estimates are attempted. For this reason, estimates of unreported income and tax gap were prepated for only three classes of illegal activities: illegal drugs, gambling, and prostitution, the three categories inlcuded in the previous IRS report on noncompliance.

These estimates should be regarded as provisional. We are working to update figures on the tax gap associated with illegal-source unreported incomes, and plan to extend the list of illegal activities estimated as well. In particular, the estimates for unreported income and tax loss associated with drug sales are likely to be revised markedly.

The previous report on unreported income contained estimates only for tax year 1976. In seeking to establish, if possible, trends in addition to levels, we developed illegal-sector estimates for 1973 and 1979 as well. Later, estimates consistent with the directions of change from 1973 to 1979 were also developed for 1981. Thus, limit-

ed as the present approach is, it nevertheless makes it possible to extend and update earlier IRS assessments of noncompliance in these three major components of the illegal sector.

As may be seen in appendix item 6, the largest of the illegal-sector tax gaps estimated here is the one associated with the traffic in heroin, cocaine, and marijuana. In 1981, for example, the tax gap of $6.1 billion stemming from an estimated $23.4 billion of unreported illegal drug income is more than twice as large as the tax gaps associated with hidden incomes from illegal gambling and prostitution combined.

CONCLUSION

Mr. Chairman, I have attempted to summarize as briefly as possible some of the highlights of our research into income tax compliance, and in doing so have tried to focus on the information presumably of most interest to policy officials such as you and the Members of the committee.

As I'm sure you are aware, any such summary necessary glosses over a number of points which may be of interest to those who desire an in-depth look at this area. For those individuals, our complete estimates—including technical appendices—will be available in the near future. Those interested in a copy of these estimates and appendices, as well as copies of this statement, should write directly to the IRS Forms Distribution Center, P.O. Box 25866, Richmond, Va. 23260.

My associates and I will be pleased to try to answer any questions you or the Members may have.

APPENDIX

IRS STATEMENT ON TAX COMPLIANCE BEFORE THE SENATE FINANCE COMMITTEE

Item number and subject

1—Income Tax Gap, 1973–81.
2—Unreported Legal-Source Income of Individual Filers and Nonfilers, 1973–81.
3—Voluntary Reporting Percentages for Individual Filers and Nonfilers by Source of Income, 1973–81.
4—Unreported Legal-Source Income and Overstated Offsets to Income, Individual Income Tax, 1981.
5—Tax Gaps for Corporations, Unrelated Business Income Tax of Tax-Exempt Organizations, and Fiduciaries, 1973–81.
6—Partial Tax Gap Estimates for the Illegal Sector, 1973–81.

ITEM 1.—INCOME TAX GAP, 1973–81

[Amounts in billions of dollars]

	1973	1976	1979	1981
Legal sector tax gap, total	28.8	39.2	62.3	81.5
Corporation tax gap, total	3.5	4.6	6.4	6.2
Individual tax gap, total	25.3	34.6	55.9	75.3
Individual income tax liability reporting gap, total	23.8	32.2	50.6	68.5
Nonfilers' income tax liability (Net of prepayments and credits)	0.9	1.4	2.0	2.9
Filers' income tax liability:	22.9	30.8	48.6	65.6
Unreported income	17.3	24.2	38.4	52.2
Overstated business expenses	2.1	3.4	4.7	6.3
Overstated personal deductions [1]	3.4	3.0	5.0	6.6
Net math error	0.1	0.2	0.5	0.5
Individual income tax remittance gap, total	1.5	2.4	5.3	6.8
Employer underdeposit of withholding [2]	1.1	0.9	1.8	2.4
Individual balance due after remittance	0.4	1.5	3.5	4.4
Illegal sector tax gap (partial) [3]	2.1	3.4	6.3	9.0
	(0.8)	(1.3)	(2.2)	(3.2)

[1] Includes itemized deductions, personal exemptions, and statutory adjustments.
[2] Also includes a small amount for underreported withholding by employees and a small negative amount for underclaimed withholding by individuals.
[3] Includes income from illegal drugs, illegal gambling, and prostitution only. Figures in parentheses are standard errors.

ITEM 2.—UNREPORTED LEGAL-SOURCE INCOME OF INDIVIDUAL FILERS AND NONFILERS, 1973–81

[In millions of dollars]

	1973	1976	1979	1981
Wages and salaries	33,304	46,274	71,076	94,581
Dividends	1,920	3,638	5,528	8,747
Interest	4,440	6,763	11,548	20,479
Capital gains	5,015	9,935	16,283	17,727
Nonfarm proprietor income and small business corporation income (except informal supplier income)	23,906	32,565	47,246	58,400
Farm proprietor income	5,742	4,542	7,832	9,547
Informal supplier income	10,346	12,721	16,995	17,080
Pensions and annuities	3,123	4,067	6,258	8,799
Rents	1,335	2,390	2,711	3,049
Royalties	312	1,088	1,672	2,770
Estate and trust income	487	695	1,140	1,330
State income tax refunds, alimony, and other income	3,990	6,857	6,260	7,166
Total income[1]	93,919	131,535	194,548	249,675

[1] Total may not equal sum of components due to rounding.

ITEM 3.—VOLUNTARY REPORTING PERCENTAGES FOR INDIVIDUAL FILERS AND NONFILERS, BY SOURCE OF INCOME, 1973–81

	1973	1976	1979	1981
Wages and salaries [1]	95.4	94.9	94.4	93.9
Dividends	90.7	87.1	85.7	83.7
Interest	87.6	88.1	86.3	86.3
Capital gains	75.7	64.3	63.4	59.4
Nonfarm proprietor income and small business corporation income (except informal supplier income)	84.0	82.2	80.7	78.7
Farm proprietor income	88.6	92.6	89.5	88.3
Informal supplier income	20.7	20.7	20.7	20.7
Pensions and annuities [1]	81.5	85.3	85.0	85.2
Rents	94.7	94.0	95.4	95.6
Royalties	74.3	65.6	64.2	61.2
Estate and trust income	82.0	79.2	75.7	76.2
State income tax refunds, alimony, and other income	66.0	55.2	62.3	62.0
Total income	91.2	90.4	89.8	89.3

[1] Before correcting for pensions misreported as wages. After this correction the VRP's affected would be modified as shown below:

Wages and salaries	95.3	94.9	94.4	93.9
Pensions and annuities	83.5	86.9	86.7	86.9

ITEM 4.—UNREPORTED LEGAL-SOURCE INCOME AND OVERSTATED OFFSETS TO INCOME, INDIVIDUAL INCOME TAX: 1981

[In millions of dollars]

Type of income or offset to income	Filers	Nonfilers	Total
Wages and salaries	18,881	75,700	94,581
Dividends	6,596	2,151	8,747
Interest	12,120	8,359	20,479
Capital gains	15,241	2,486	17,727
Nonfarm proprietor income (except informal supplier income)	33,615	10,561	44,176
Farm proprietor income	8,499	1,048	9,547

ITEM 4.—UNREPORTED LEGAL-SOURCE INCOME AND OVERSTATED OFFSETS TO INCOME, INDIVIDUAL INCOME TAX: 1981—Continued

[In millions of dollars]

Type of income or offset to income	Filers	Nonfilers	Total
Partnership and small business corporation income [1]	10,786	3,439	14,225
Informal supplier income	13,848	3,232	17,080
Pensions and annuities	4,131	4,668	8,799
Rents	2,637	412	3,049
Royalties	1,866	904	2,770
Estate and trust income	646	684	1,330
State income tax refunds, alimony, and other income	4,975	2,191	7,166
Total unreported income	133,840	[2] 115,835	249,675
Overstated business expenses	16,179	n.a.	16,179
Overstated statutory adjustments	1,803	n.a.	1,803
Overstated personal deductions	6,958	n.a.	6,958
Overstated exemptions	8,060	n.a.	8,060
Total overstated offsets [3]	33,000	n.a.	33,000
Total misreporting [4]	166,840	115,835	282,675
Gross tax gap [5]	65,600	5,042	70,642
Unclaimed prepayments and credits	n.a.	2,185	2,185
Net tax gap	65,600	2,857	68,457

n.a. indicates not applicable.
[1] Such income, which for tax purposes is treated as partnership income, is taxable to stockholders as ordinary income whether or not distributed.
[2] Includes business income on a net income basis.
[3] Excludes credits which are offsets to tax liability.
[4] This is the sum of "Total unreported income" and "Total overstated offsets."
[5] Tax liability based on total misreporting.

Note: Sum of components may not add to totals due to rounding.

ITEM 5.—TAX CAPS FOR CORPORATIONS, UNRELATED BUSINESS INCOME TAX OF TAX-EXEMPT ORGANIZATIONS, AND FIDUCIARIES, 1973–81

[In millions of dollars]

Tax gap category	Tax year			
	1973	1976	1979	1981
Corporations [1]	3,469	4,462	6,212	5,999
Exempt organizations income tax	34	76	104	109
Fiduciaries	41	42	69	108
Total	3,544	4,580	6,385	6,216

[1] Includes an estimated amount for delinquent returns ranging from $10 million to $18 million.

ITEM 6.—PARTIAL TAX GAP ESTIMATES FOR THE ILLEGAL SECTOR, 1973–1981

[In billions of dollars]

	Tax Gap			
	1973	1976	1979	1981
Illegal drugs [1]	1.2	1.9	4.1	6.1
(Standard error)	(0.6)	(0.9)	(1.7)	(2.6)
Illegal gambling	0.4	0.6	0.7	0.9
(Standard error)	(0.1)	(0.2)	(0.3)	(0.3)
Prostitution [2]	0.6	1.0	1.5	1.9
(Standard error)	(0.6)	(0.9)	(1.5)	(1.9)
Total [3]	2.1	3.4	6.3	9.0

ITEM 6.—PARTIAL TAX GAP ESTIMATES FOR THE ILLEGAL SECTOR, 1973–1981—Continued

[In billions of dollars]

	Tax Gap			
	1973	1976	1979	1981
(Standard error) [4]	(0.8)	(1.3)	(2.2)	(3.2)

[1] The drugs included were limited to heroin, cocaine, and marijuana.
[2] Female prostitution only.
[3] Total may not equal sum of components due to rounding; total standard error will not equal sum of components due to offsetting errors in the calculation of total error.
[4] An estimate plus or minus twice its standard error would yield a range that has a 0.95 probability of including the true value of that which is being estimated.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Mr. CHAPOTON. Well, unfortunately, I'm afraid we don't have a lot of ideas that will close the gap completely. We do want to suggest a couple—more than a couple.

There are a couple of points, though, preliminarily, that I would like to make, Mr. Chairman.

First is that we keep in mind the significance of last year's legislation toward closing the tax compliance gap. With Treasury's active participation and this committee's work and the Congress work, you adopted title III of TEFRA, which is certainly the broadest collection of new provisions dealing solely with Federal tax compliance at any one time in the history of the Internal Revenue Code.

I list in my statement all or most of the items in title III dealing with compliance. I would point out two, particularly:

One is the new penalty and enforcement mechanism dealing with abusive tax shelters, and the other is the penalty on substantial understatement of tax from overly aggressive nondisclosed returns filing positions. That is a new concept, and we think it may bear substantial fruit.

The CHAIRMAN. Could you go over that again?

Mr. CHAPOTON. I am talking about the substantial understatement penalty that was adopted last year.

The CHAIRMAN. Right.

Mr. CHAPOTON. It is a new concept. It does mean the taxpayer simply cannot, with impunity, play the audit lottery.

We would point out that where changes were made in TEFRA, further changes could now be premature. Taxpayers, IRS agents, and withholding agents, the persons who must deal with the information returns, are currently working with the new provisions. They are having some learning period on our side and their side as well, and so I think we should be careful about burdening the entire group—both sides, Government and the private sector—with new legislation at this time.

We think we should not hesitate to look at new areas, and we are continually studying the compliance problem. As we find solutions to these old problems, we will certainly bring them to the attention of this committee, and I do want to mention six in our statement that we suggest the committee might look at right now:

The first is providing greater ability of the Service to insure consistent treatment of a single transaction by two taxpayers involved in the transaction by specifically allowing the Service to require a taxpayer who reports an alimony deduction, for example, and gives the name of the payee also to give the taxpayer identification number. That concept could be applied in other areas. The Service can then quite easily make sure that there is not inconsistent reporting of the payment. This requires no additional filing by the taxpayer and places very little burden, therefore, on taxpayers.

The second item is identifying tax shelter investors. In some cases it is not clear whether under current law the tax shelter promoters are required to keep a list or a record of investors. This principally arises where the form of the investment is not a partnership, and therefore when the IRS discovers in an audit of one of the investors that the tax shelter looks improper, it is difficult to run it down to the other investors. We think the law should require specificially that the promoter maintain a list of investors for a 7-year period.

The third area is the estate and gift tax penalties. We note that the penalties imposed in the income tax area recently, three separate categories of penalties, were not imposed in the estate and gift tax area. We think they should be, that the noncompliance problem is the same in the transfer tax system, and the penalties should be imposed there as well.

The fourth area that we mention is a recent development, and we think a potentially serious development, that is the availability of so-called audit insurance. This insurance indemnifies taxpayers against liability for tax deficiencies assessed by the IRS following an audit. We think that the availability of this insurance diminishes in an important way the incentive of taxpayers to assess their tax liability properly. Although the insurance, as we understand it, does not apply to conduct that is fraudulent, there are many cases where the IRS does not assert a penalty because of resource constraints or the desire to settle the case, but yet the taxpayer's efforts to self-assess has fallen far short of the mark.

We think that the existence of audit insurance violates public policy in that it encourages wrongful conduct by permitting taxpayers to insure against their wrongful acts.

We don't have a proposed solution for the committee, but we think this is an important problem, and we would like to work with the committee in developing a solution.

The fifth area mentioned is improper accounting methods. Under existing law a taxpayer is not permitted to change accounting methods without permission of the Commissioner. We think that that may enable taxpayers to argue that they can continue to use an improper method and cannot be assessed any penalties for doing so because they have neither sought nor been granted permission to change to a proper method of accounting.

We think that when the return is filed and an impermissable method is utilized the taxpayer should be required to request permission to change, to indicate that it is an improper method, and in a proper case that it would be subject to penalties for failing to do so. It is inconsistent with proper self-assessment of tax liability to continue to use an improper method and therefore improperly

report income by reason of the rule on change in method of accounting.

Finally, let me mention a problem we see in connection with appraisals of property and the possible inability of Treasury to regulate appraisers who appear before the Internal Revenue Service.

In our view, the overstatement of deductions and credits based on the overvaluation of assets and services is one of the more serious problems facing our self-assessment system. Unfortunately, the participation of appraisers often has been a key to these overvaluations.

There is a penalty that was adopted in ERTA on taxpayers who take overly aggressive valuation positions, but we don't think the penalty on taxpayers is sufficient, because in some cases taxpayers rely on improper valuations in reliance on an appraisal that they don't have any reason to know is defective.

The Treasury Department does have authority to disqualify from practice before it a representative of the taxpayer who engages in disreputable conduct or is incompetent. We think such a rule should be extended to appraisers where conduct is clearly disreputable, such as by furnishing an appraisal that is palpably incorrect, either with the intention of materially misstating the value of an asset or through gross negligence. We think if an appraiser has been guilty of such conduct he should not thereafter be permitted to render opinions in proceedings before the Treasury Department.

I do mention also our concern about tax evasion or avoidance in the international area. We are not suggesting that everything needs to be done on that in the legislative arena at this time. We are pursuing and need to continue to pursue, hopefully with the support of this committee, broader exchanges of tax information through income tax treaties or through bilateral exchange of information agreements. That effort is ongoing and does not come to the immediate attention of this committee, but we do want to bring it to the attention of this committee from time to time.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY) DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the committee: I am pleased to have the opportunity to present the views of the Treasury Department on possible future legislation dealing with Federal tax compliance.

We share the concern expressed by Commissioner Coates that a large number of taxpayers fail to meet their self-assessment responsibilities under the law, resulting in a substantial revenue loss to the Federal Government. In particular, we are concerned that the apparent failure of many taxpayers to comply with the law adversely affects other taxpayers' willingness to fulfill their responsibilities to comply with the law.

Last year, with the Treasury Department's active assistance, the Congress undertook a far-reaching review of tax compliance issues. The result of this review was Title III of the Tax Equity and Fiscal Responsibility Act of 1982 [TEFRA], the broadest collection of new provisions dealing solely with Federal tax compliance in history.

The provisions of Title III included:

Withholding at source on interest and dividends;

A greatly enlarged system of information reporting on taxpayer receipts of interest, tips received by employees of the food and beverage industry, refunds of state and local income taxes, purchases of property for resale from direct sellers, and sales of capital assets through brokers;

A requirement that debt obligations of all issuers (the Federal Government, private issuers, and state and local governments) be issued in registered form;

Increased penalties for failure to comply with the information reporting requirements, and a system of backup withholding for persons who fail to provide a taxpayer identification number to, or to correct the taxpayer identification number on file with, persons required to file information returns;

New penalties and enforcement mechanisms applicable to promoters of abusive tax shelters;

A penalty for substantial understatements of tax based on overly aggressive, nondisclosed return filing positions;

A civil penalty for knowing preparation of documents that understate tax liability;

A penalty for filing a frivolous tax return;

Major increases in the level of fines for tax crimes;

Broadened jeopardy and termination assessment procedures to deal with large amounts of unclaimed cash;

Streamlined procedures for enforcement of administrative summonses;

Revised withholding procedures for pension and retirement plan distributions;

Improved administrative capability for the Internal Revenue Service to examine foreign transaction;

Modernization of the computation of interest on overpayments and underpayments of tax; and

A streamlined procedure for entity level audits of partnerships.

Other important compliance provisions enacted recently are the corporate level audit of S corporations added by the Subchapter S Revision Act of 1982 and the penalty on valuation overstatements added by the Economic Recovery Tax Act of 1981 [ERTA].

Although we have serious concern about the magnitude of the tax gap and its implications for our self-assessment system, the breadth and scope of the compliance measures contained in Title III of TEFRA—many of which represented innovative conceptual approaches to difficult compliance issues—raise two questions regarding additional compliance legislation:

First, even the most preliminary appraisal of the TEFRA compliance measures is not yet possible. Virtually none of the TEFRA provisions have had an opportunity to affect tax compliance in ways that can be measured; indeed, some of the provisions have yet to take effect.

Second, TEFRA, in combination with ERTA, is responsible for a prominent fact of life in the tax world today: taxpayers, tax professionals, and the IRS are engaged in the difficult task of adapting to the numerous rules, requirements, and procedures enacted in the last two years. While we should not hesitate to make changes in the law when called for, we must be mindful of the finite ability of both the private sector and the Government to adapt to change. Major revisions in the law are made at material cost—in actual private and public sector expenditures to understand and implement the changes, as well as in the confusion and dislocation that inevitably results. In fact, continued changes in the tax law could well lead to disaffection and noncompliance among taxpayers—precisely the opposite of the effect we are seeking to achieve.

In approching possible legislative action this year, we must bear in mind that, in some areas, changes were made in TEFRA, and that further changes could be premature. Taxpayers, persons required to file information returns, withholding agents, and IRS personnel currently working with new provisions should not be burdened with new legislation at this time. We should not hesitate, however, to explore new areas. The Treasury Department is studying various compliance problems in the hope of finding new solutions to those problems, and we will bring such solutions to the committee's attention as they are developed. We can, at this time, call this committee's attention to certain areas we think should be dealt with legislatively as soon as possible.

Although we do not wish to make any proposals in the withholding area, I think it appropriate to note here that, in our view, withholding at source remains the single most effective means of assuring that taxpayers pay the tax they owe. We recognize that many persons have expressed concern that withholding on interest and dividend payments—which formed the cornerstone of the TEFRA compliance provisions—is not an acceptable compliance measure. As a result, it appears likely that the Congress will approve legislation repealing interest and dividend withholding. Obviously, this development will represent a substantial reversal in the effort to collect taxes that are due before imposing new taxes on persons that pay their

taxes. This reversal is particularly unfortunate in light of the level of current deficits.

Although we continue to believe that withholding represents sound tax policy, we applaud this Committee's efforts to achieve a compromise in the withholding area, reflected in the Committee amendment to H.R. 2973. The Treasury Department supports the amendment and hopes that the House-Senate Conference Committee will adopt the Senate withholding provision promptly.

I will now discuss six compliance problems that we believe the Congress should consider. These are:

(1) *Insuring consistent reporting by taxpayers.*—The desirability of confirming the IRS' authority to require taxpayers claiming deductions or otherwise reporting certain types of transactions on their returns to indicate the taxpayer identification number of other parties to the transaction on the return to enable the IRS to insure consistent reporting for both parties;

(2) *Identifying tax shelter investors.*—The ability of promoters of certain tax shelters to frustrate the IRS in pursuing investors by failing to maintain records of investors;

(3) *Estate and gift tax penalties.—The need to amend the Internal Revenue Code provisions imposing penalties on return preparers, substantial understatements of tax, and improper valuation of property so that they apply to the estate and gift taxes;*

(4) *Audit insurance.*—The potential damage to our self-assessment system resulting from the availability of so-called audit insurance against tax deficiencies;

(5) *Improper accounting methods.*—The uncertainty whether business taxpayers may understate taxable income without risk of penalty by continuing to use improper methods of accounting; and

(6) *Appearance of appraisers before treasury.*—The need to clarify when appraisers will be disqualified from appearing before the Treasury when they have engaged in disreputable conduct.

I will elaborate on each of these measures in turn.

(1) INSURING CONSISTENT REPORTING BY TAXPAYERS

Our first suggestion involves the IRS' expanded use of information currently provided on tax returns. Information reporting by third parties concerning taxable receipts, transactions, or items of deduction or exclusion is an important means of securing tax compliance. The IRS uses these information reports—typically filed on form 1099—to verify that items such as interest, dividends, proceeds of capital transactions and cost of goods acquired from direct sellers have been reported correctly on returns filed by taxpayers. Many information reports are matched by computer against returns of tax filed by taxpayers. If a discrepancy is discovered, the IRS can commence an audit solely on the basis of the discrepancy or correspond with the taxpayer, auditing the return only if the discrepancy is not resolved through correspondence. Additionally, information reports can be used to locate taxpayers who improperly fail to file tax returns.

We suggest that the Internal Revenue Code be amended to confirm the authority of the IRS to require that taxpayers, in filing their tax returns, must provide the taxpayer identification numbers of persons to whom the taxpayer has made a payment, with whom the taxpayer have engaged in a transaction, or the like, when such information is requested specifically. This will assist the IRS in making greater use of information currently provided on tax returns to insure consistent treatment between taxpayers. Under this authority, the IRS will require taxpayer identification numbers as to certain specified types of transactions, or other items, so that taxpayer's reporting can be compared to the reporting of other parties. For example, a tax return showing alimony deducted by a divorced spouse could be compared to the tax return filed by other spouse. This form of information reporting is very promising, since it requires no additional filings with the IRS and therefore places very little burden on reporters.

Selective return comparison on audit requires only limited data processing capacity and could commence relatively quickly. The IRS can, in examining an individual case, very easily locate the return of the other party to a transaction using the taxpayer identification number provided on the taxpayer's return.

(2) IDENTIFYING TAX SHELTER INVESTORS

Our second recommendation will enable the IRS to pursue investors in certain tax shelters more effectively. Present law is unclear whether tax shelter promoters in all cases are required to maintain records of investors. This question arises chiefly

where the tax shelter is not organized as an entity such as a partnership. As a result, if the IRS discovers an improper tax shelter through the audit of one investor, the IRS has experienced difficulty in locating other investors through the promoter. We recommend that tax shelter promoters be required to maintain a list of investors for a period of seven years after the investment has been sold. Failure to maintain such records should be subject to a meaningful penalty.

(3) ESTATE AND GIFT TAX PENALTIES

Three of the recently enacted compliance provisions do not apply to the estate or gift tax. There are: the rules regarding income tax return preparers enacted in 1976, the rules regarding improper valuations of property on income tax returns enacted in 1981, and the rules regarding substantial understatements of income tax enacted in 1982.

Given that self-assessment principles are no less critical to the collection of the transfer taxes than they are to the income tax, we think that any compliance measure should broaden the application of these penalties to encompass transfer taxes. (I note that the penalty for aiding and abetting understatements of tax liability added by TEFRA currently applies to transfer tax returns.) Although there is some uncertainty associated with application of these penalties in the transfer tax area, primarily in the valuation of some types of property, we think that the structure of the penalty provisions generally is adequate to take into account good faith errors. We recognize that particular care is required in adapting the 1981 penalty on improper valuation to the transfer taxes, as the estate and gift taxes in certain instances require difficult valuations not required under the income tax.

(4) AUDIT INSURANCE

We wish to note a recent development that could undermine seriously the self-assessment structure of the Internal Revenue Code—the availability of so-called audit insurance. This insurance indemnifies taxpayers against liability for tax deficiencies assessed by the IRS following an audit. In our view, the availability of this insurance diminishes in an important way taxpayers' incentives to assess their tax liability properly. At present, taxpayers have some level of concern that they will be selected for audit and a tax deficiency imposed if they take overly aggressive return filing positions. Audit insurance, in effect, removes the basis for that concern. Although, as we understand it, the insurance does not apply to conduct that is fraudulent, it is clear that there are many cases where the IRS does not assert penalties—due to resource constraints, the desire to secure prompt settlements, or other reasons—but yet the taxpayer's effort to self-assess tax has fallen far short of the mark.

In our view, audit insurance violates public policy in that it encourages wrongful behavior by allowing taxpayers to insure against the consequences of wrongful acts. Under the law, insurance against wrongful acts is permitted only when the insurance has independent social value. For example, automobile insurance covers accidents that involve violations of state motor vehicle laws, because the benefit to society of reimbursing the costs of such auto accidents—including costs incurred by innocent victims—far outweighs whatever minor encouragement of illegal operation of motor vehicles may result from such insurance. In contrast, permitting a taxpayer to avoid liability for taxes owed by providing reimbursement where noncompliance is detected has no discernable social benefit and can only result in increased contempt for, and noncompliance with, the tax laws.

In short, we are concerned that audit insurance may have significant undesirable effects on tax compliance. We look forward to working with this committee in addressing this concern.

(5) IMPROPER ACCOUNTING METHODS

We wish to recommend a change to section 446 of the Internal Revenue Code in order to clarify that part of a taxpayer's obligation to self-assess tax due includes an obligation to use a proper method of accounting. Under the Internal Revenue Code, taxpayers generally are required to secure permission from the IRS in order to change a method of accounting. This rule may enable taxpayers to argue that they can ignore proper tax accounting rules and avoid any penalty for so doing merely because they had not sought (and therefore had not received) permission to change to a proper accounting method. We believe that it is consistent with taxpayers' general obligation to self-assess their tax liability to require that taxpayers who are using an impermissible method of accounting request permission to change to a permissible method when filing their tax return. In addition, where taxpayers fail to

request such permission, they should, in proper cases, be made subject to the penalties currently provided in the Internal Revenue Code to the same extent that any other form of improper assessment of income or deduction items may give rise to a penalty.

(6) APPEARANCE OF APPRAISERS BEFORE TREASURY

Finally, we believe that clarification of the Treasury Department's authority to regulate appraisers who appear before it is needed. In our view, the overstatement of deductions and tax credits based on the overvaluation of assets and services is one of the most serious problems facing our self assessment system of taxation today. Unfortunately, the participation of appraisers often has been the key to these overvaluations.

Although the ERTA penalty on valuation overstatements imposes liability on taxpayers who take overly aggressive valuation positions on income tax returns, we do not think it is enough to provide a penalty on the taxpayer. Some improper valuations on tax returns are the result of taxpayers' reliance on appraisals that the taxpayers had no reason to know were defective. For example, certain tax shelters in which valuation of a property is central to the tax results are sold using an apparently sound appraisal as part of the sales materials.

The Treasury Department has the authority to disqualify from practice before it any representative of taxpayers who has engaged in disreputable conduct or is incompentent. We think this rule should be extended to include the presentation of opinion evidence by an appraiser who has engaged in disreputable conduct—such as by furnishing an appraisal that is palpably incorrect either with the intention of materially misstating the value of an asset or as a result of gross negligence. If an appriaser is guilty of such conduct, he should not thereafter be permitted to render opinions in proceedings before the Treasury. Although the penalties provided in sections 6700 and 6701 of the Internal Revenue Code for promoting abusive tax shelters and preparing knowingly false tax documents probably would apply to such conduct, we believe that the authority to sanction the appraiser before the Treasury is appropriate. The finding that an appraiser has engaged in such disreputable conduct is fundamentally inconsistent with the appraiser's ostensible role as one who can provide the Treasury a trustworthy opinion regarding matters in which he is expert.

Finally, I would like to note that we are concerned about the problem of tax evasion in the context of international transactions. The use of foreign trusts and other entities as well as secret bank accounts is a serious compliance problem. One solution to this problem may lie in increased international cooperation in tax administration.

Obtaining cooperation from foreign countries is particularly difficult in the case of those countries whose economies rest in part on tax haven activities or bank secrecy laws. Proposed solutions must take account of U.S. trade and investment interests as well as our tax and law enforcement concerns. We must also respect the right of sovereign states to establish legitimate protections for their citizens. The Treasury Department is actively pursuing increased international exchange of tax information through bilateral income tax treaties and exchange of information agreements such as those contemplated by the Caribbean Basin legislation recently approved by this Committee.

In conclusion, the Treasury Department believes that the focus of Federal tax compliance concern should be on efforts to understand, implement, and evaluate the compliance provisions enacted last year. Compliance legislation this year must build on TEFRA while not detracting from these efforts.

This concludes my prepared remarks. I would be happy to answer your questions.

The CHAIRMAN. Do you have any estimate on how much these recommendations might raise? How much of that $100 billion gap are we going to close if we enact the proposals that you just suggested?

Mr. CHAPOTON. No, Mr. Chairman. These areas are rather limited areas, quite frankly, and they would not be major revenue raisers. In fact, some of them are more in the area of revenue protections, such as the audit insurance and those types of changes. So we do not.

We are still articulating the rules under the TEFRA provisions, and the possibility of going back and having significant revenue

raising in this area at this time is going to be difficult, even though the problem is here and the problem cannot be ignored.

The CHAIRMAN. Are we stepping up the audit activity? I mean, there is only about 2.3 percent of the returns being audited.

Commissioner COATES. Somewhat less than 2 percent, Senator, this coming year. I don't have an exact figure, but it is something in the neighborhood of probably 1.5 percent of the income tax returns filed.

The CHAIRMAN. It is going down instead of up, in other words.

Commissioner COATES. It is going down. Yes, sir, because the workload is increasing.

The CHAIRMAN. Have there been requests for more personnel?

Commissioner COATES. The number of returns being filed obviously is increasing, which has an impact on the number of returns we can examine with a stable work force.

The CHAIRMAN. Now, as I understand, the IRS figures show that we lose about $10 billion annually because of noncompliance with respect to illegal-source income, and it is also one of the fastest growing components. Do you have any suggestions on how we might close this gap, this illegal source income?

It has been suggested by some that we ought to require reporting of cash purchases in excess, say, of $5 to 10,000, or deposits; in other words, somebody dealing in cash—there ought to be a report if somebody buys something with $100 bills, or whatever. Has there been any consideration of anything like that by IRS or Treasury?

Mr. CHAPOTON. Well, not specifically, but certainly cash transactions are a matter of concern and clearly are a problem. We have considered that in the broader context, but, no, we have not considered any specific proposal in that regard.

The CHAIRMAN. Has there been any consideration of changing the color of the money?

Mr. CHAPOTON. That is talked about from time to time. I read it in the newspaper from time to time, but, no. There are a lot of problems in doing that, of course. So we have nothing to propose on that.

The CHAIRMAN. Senator Long?

Senator LONG. I find this difficult to believe. You are estimating that there is $6.1 billion in revenues that we are not getting on illegal drugs. I am not looking on that as any major source of revenue, because I think that making money for the Government out of that is sort of like what my grandmother used to tell me when I was a little boy. I said, "If you want to catch a sparrow, you first sprinkle salt on his tail—then you can catch him." But she said, "You can't catch him, period."

The fight against drugs, I think, is mainly just to try to stop drug traffic, not to collect the income tax. If you catch a drug dealer at all, you want to put him in the penitentiary.

Do you really think there is any substantial potential for making money for the Government on collecting an income tax from drug peddlers?

Mr. CHAPOTON. No, sir, I do not, for the very reason you stated.

Senator LONG. It seems to me as though drugs are a law enforcement problem. You are trying to put those drug peddlers in the

penitentiary, and I don't think you can potentially collect any money there.

But, Mr. Chapoton, my thought is that we ought to be checking on a great deal more taxpayers. This administration, to my understanding, came in asking that we cut the money available to the IRS to do field work, to go out there and check on taxpayers. Is that correct, or not?

Mr. CHAPOTON. Well, let me ask Commissioner Coates to comment on that. I think initially there was a cut, and then that was changed, and there has been an increase.

Commissioner COATES. Yes, Senator. Last year we had what is known as a revenue initiative. Thanks to the Congress, we have added 5000 positions which are working directly in the compliance area. Many are in the examination area, but by and large the majority are going into the collection function, which is making a substantial effort, and a successful effort, I might say, in collecting the delinquent taxes we have on the books today.

Senator LONG. How much did that cost?

Commissioner COATES. In terms of staff years?

Senator LONG. In dollars, yes for the 5000 additional people.

Commissioner COATES. I don't have the cost of the 5,225 additional positions.

Senator LONG. Couldn't you give us just a rough guess of what it cost us?

Commissioner COATES. Five thousand at $30,000 a staff year.

Senator LONG. That looks to me like about $200 million; would that be it?

Mr. CHAPOTON. $200 million.

Senator LONG. I think that most people in the country would be shocked, because it would be contrary to what they have been led to believe, to know that what we are spending on the Internal Revenue Service to collect taxes is less than one-half of one percent of the Government revenue collected. That's about correct, isn't it?

Commissioner COATES. I think that's about right.

Senator LONG. You are spending about $3 billion, and you are getting in over $600 billion. Of course a lot of it comes in voluntarily; a lot of it comes in because people honestly pay as they should.

I just don't understand why we don't employ more people to go out and get the money that's due. For example, I didn't vote for withholding on interest, but my thought is that you've got all of the information you need, and that Treasury just doesn't want to be bothered going out to collect what is due. You have the information, you've got the fellow's tax return, the banks are perfectly willing to cooperate in matching up the tax returns with the information that they have, and where the taxpayer has paid it seems to me somebody ought to just go dun them, just say, "You owe us," and call upon them to pay. For the life of me, I can't believe you would have any difficulty getting that money if you would just call on them.

Mr. CHAPOTON. Senator, I think as we have said many times before, the matching helps. It is the first step in the collection process. And after that it is simply a resource allocation in corresponding with the taxpayer or, if necessary, actually auditing the taxpayer.

There is no question—Mr. Coates can say this better than I, but I can it say confidently—that taxpayer contacts produce money, produce receipts. Where there is noncompliance, potentially or otherwise, taxpayer audit activity and correspondence with taxpayers does produce receipts. It is simply a resource allocation question, though, of how you best carry on that taxpayer contact.

Senator LONG. My thought is that we ought to hire large numbers of people, both as additional agents for IRS and even to hire people on a fee basis or a contingency basis to go out and collect taxes owed.

When I started out—I don't know whether it still is the case, but I suppose it is—a lot of young lawyers who didn't get an offer from a big firm would start out their law practice by going out and collecting bills for people. You know, it is standard on notes you have to collect, and that sort of thing, to pay a 20-percent fee if people have to go sue to collect it.

Why don't we do something like that, to go out and put large numbers of people to work getting the money in. For the life of me, I can't understand why we wouldn't be willing to pay as much as 20 percent for people to go out and collect taxes from the people who didn't report their full income and didn't pay all the taxes they owed. Why don't we do something like that?

Mr. CHAPOTON. Let me comment on one side of it, then Commissioner Coates can add his thoughts.

We always have the problem, even now, with the IRS agents who are carefully trained, who are carefully advised on the rights of taxpayers and how they should conduct themselves, we still have problems that people think the IRS is too heavyhanded. I think if we go beyond the Government employees we would exacerbate those problems.

Reliance should be—to the extent it can be—on voluntary compliance, certainly motivated by the thinking that if you don't voluntarily comply you have a good chance of being caught. Again, it is the problem of whether we have enough resources, or whether we want to apply more resources to this endeavor, or whether it begins to look too much like a police state.

Senator LONG. Well, to me it is just patently ridiculous for the Department to come in here and tell us that you are losing $90 billion on people who are just not paying up—I am not talking about people engaging in crime, just ordinary taxpayers not reporting income and not paying taxes. To me it is incredible to say that this is going on and you are not in here asking us for about $5 billion more to hire people to go out and get those taxes. That would be a good investment. If I could get $20 for every $1 I spend collecting it—I would consider that a very good deal.

As far as the businessman is concerned, he is perfectly willing to pay lawyers 20 percent to go out and get the money that is owed him, and I for the life of me don't understand why the Treasury doesn't do more of that.

I would think that some of the same people that represent the taxpayers would be glad to make themselves available to you to go sue the other crowd, as long as it is not their client. [Laughter.]

At the time I started out practicing law, I would have been delighted to do this. I would probably have made me some clients out

of it, if I worked hard at it. If a guy was working that hard to get money for the Government, some potential client might say: "Gee, if he works that hard to get money for the Government, maybe he would work that hard to help me save some."

It seems to me that you ought to go out and hire people to collect those taxes, including the people right now who are working for the other side. There are 50,000 tax lawyers out there working for the other side—hire some of them. Let them work both sides of the fences. [Laughter.]

As a matter of fact, Mr. Chapoton, one of my understandings is that the people who are good, creditable, respected tax lawyers really feel that one of the things that makes it tough on their profession is that so many crooks get away with not paying taxes because some tax lawyers advise people just not to report income from crooked and dishonest things. It makes it sort of tough on the honest practitioner. Isn't that correct?

Mr. CHAPOTON. Well, that is absolutely correct. It is a problem for every good tax adviser that he is giving advice that, if other advice is sought, may not be respected. And the taxpayer at some point may not have an incentive to get good advice any more, to ask for good advice. That is a real concern. I agree.

Senator LONG. We only have 2 minutes to answer the rollcall. We would ask you to stick around.

[Whereupon, at 11:58 a.m., the hearing was recessed.]

AFTER RECESS

The CHAIRMAN. I am not certain Senator Long will be coming back, but I share the general views he has expressed on trying to collect the taxes that are due with more personnel. In fact, I think the record shows that in the withholding debate, in an exchange of letters with Senator Hatfield, the chairman of the Appropriations Committee, he did indicate full support for additional funding to help us with backup withholding. So there is that congressional support. I think it is also as strong or stronger on the House side, not only in the withholding area but in other areas where people aren't paying taxes.

If we don't have any way to collect it without more personnel, then I assume we have some responsibility to the honest taxpayers to try to collect what is due.

And I assume we will take a look at the six suggestions made, but I hope there are other suggestions that may be coming from IRS and Treasury.

Mr. CHAPOTON. We will certainly continue to look at the problems, Mr. Chairman. There are problems.

It is frustrating to see the dollar figures that the Commissioner quotes and not be able to make more use of them.

The CHAIRMAN. It occurs to me, unless we indicate a strong commitment to collect taxes, there are going to be more and more people saying: "Why should I pay mine, if they are not paying theirs, or they are not paying what they owe."

And even there are still people wiggling around trying to get around last year's even reporting requirements. We will have one of those witnesses—the National Restaurant Association will be on

later. It is hard to get people to cooperate. It is complicated, and if we can't do it the way we've done it, we will have to find another way to raise the revenue.

I don't have any further questions, but we will be working with you; because if this committee is required to raise revenue, I assume we will have to find some difficult ways to do it—I don't know of any easy ones. This would be the easiest, but apparently we can't collect it, or we can't collect much of it.

Thank you very much.

Mr. CHAPOTON. Thank you.

The CHAIRMAN. I think I am going to add Mr. Henry to the next panel. I am having difficulty finding other members to chair this hearing, so I hope to complete it by 1.

Mr. Henry will be joined by Mr. Aidinoff, chairman of the section of taxation, American Bar Association; Donald Skadden, associate dean, Graduate School of Business Administration, on behalf of the American Institute of Certified Public Accountants; and Willard Taylor, accompanied by Michelle Scott who used to work for us from time to time. It's good to see you back on behalf of the New York State Bar Association.

Let's see. Mr. Henry, please go ahead. You are first.

STATEMENT OF JAMES S. HENRY, McKINSEY & CO., NEW YORK, N.Y.

Mr. HENRY. I detect a note of impatience with estimates in the committee's questioning.

The CHAIRMAN. Well, we get all of the estimates. Nobody tells us how to close the gap.

Mr. HENRY. I have some suggestions.

The CHAIRMAN. Oh, good.

Mr. HENRY. I am pleased to appear today at the committee's invitation to discuss the problem of tax compliance and the long-awaited IRS tax-gap estimates.

I am going to summarize quickly the merits and limitations of those estimates and then move on to summarize the next steps for compliance research that I see as critical. If time permits, I will conclude with a few observations about possible policy alternatives.

I am an economist and lawyer with McKinsey & Co. in New York. For the past 6 years I have conducted research on various aspects of the underground economy, of which tax evasion is undoubtedly the leading sector.

Most recently I presented the basic discussion paper on this sector's size and growth at an invitational conference on income tax compliance sponsored by the American Bar Association.

My role at the conference was to review the evidence on the overall size, growth, and composition of noncompliance in the United States. In the course of that review I took a close look at the half dozen or so different approaches to measuring noncompliance that have emerged in the last 5 years, including those used by the IRS.

At the time I wrote the conference paper, only preliminary estimates were available from the IRS' most recent study. These were originally presented to this committee in March 1982. As I write

this testimony, I have still not had a look at the IRS' revised estimates, but I am told that the revisions, while significant, are mainly technical in nature, so that most of my major conclusions about the estimates still apply.

What do we want such estimates for? It seems to me that policymakers need estimates of noncompliance that do at least three things:

First, we want them to describe the overall problem accurately in terms of its size, growth, and composition.

We want the estimates to point toward explanations for observed trends in noncompliance.

We want them to help us weigh the costs and benefits of specific compliance policies.

How well have the IRS estimates met these needs? First of all, I think the latest IRS estimates are an innovative, substantial contribution, a substantial improvement over its earlier efforts. In light of this achievement I believe that continued IRS research efforts in this area should be vigorously supported. However, I want to emphasize that the latest estimates satisfy none of the three needs that I described above.

At the descriptive level, the IRS estimates have serious definitional flaws. They fail to analyze the distribution of noncompliance in the taxpayer population as a whole. They include estimates for illegal-source income that are largely meaningless. It just seems very peculiar to estimate a tax gap for activities that we prefer did not occur in the first place.

The omission from the estimates of noncompliance with State and local taxation and Federal and payroll taxes is a serious one.

Finally, there is a heavy reliance in these estimates on a procedure for scaling-up TCMP estimates of noncompliance that is untested and perhaps unreliable.

At the level of providing an explanation for noncompliance, this latest study offers no theory to help us sort out the factors responsible, and essentially assumes that increased enforcement efforts would leave taxpayer behavior completely unchanged.

At the level of policy evaluation, the latest estimates address only the revenue side of the question. They have nothing to say about the costs of achieving increased compliance.

So, while these estimates may be a good foundation for further research, and while that research should be supported, their actual implications for compliance policy are very limited. They cannot be used to measure the net revenue gain from specific policy initiatives. They cannot be used to target enforcement efforts. They cannot be used to understand whether compliance is growing or shrinking relative to the rest of the economy. They cannot be used to project what our future compliance problems will be like.

This critique of the IRS estimates suggests agenda for further research. The most important item on this agenda is to understand the factors—tax rates, sanctions, structural change, public opinion, and so forth—which are responsible for trends in noncompliance.

The second item is to understand the cost, public and private, of achieving improved compliance.

The third is to evaluate the role of tax preparers in the compliance process, since over 40 percent of individual returns are filed

by paid preparers, and since there is evidence that compliance is lower for those returns.

Finally, we need to analyze the distribution of noncompliance in the population as a whole in order to distinguish between noncompliance that is widely scattered throughout the population, and hard to get at through enforcement remedies, from noncompliance practiced by "professional evaders" people evading large amounts of tax on their incomes.

These are the next steps that I see as necessary to meet the needs that we described earlier. The need for description, evaluation, and explanation.

The CHAIRMAN. Thank you very much.

[The prepared statement follows:]

STATEMENT OF JAMES S. HENRY, MCKINSEY & CO., NEW YORK, N.Y.

INTRODUCTION

I am pleased to appear today at the Committee's invitation to discuss the problem of tax compliance and the IRS's latest "tax gap" estimates. In today's testimony, I will focus on two main topics:

The merits and limitations of the IRS's estimates;

The next steps in compliance research that I see as critical.

BACKGROUND

I am an economist and lawyer with McKinsey & Co. in New York. For the past 6 years I have conducted research on various aspects of the underground economy, of which tax evasion is undoubtedly the leading sector. Most recently, I presented the basic discussion paper on this sector's size and growth at an invitational conference on income tax compliance sponsored by the American Bar Association. That conference, held last March, brought together more than 100 leading tax professionals, scholars, and public officials to examine the dimensions of noncompliance, the factors responsible for it, and potential remedies. The conference produced a stimulating exchange of ideas, but no "magic bullets." Indeed, there was a general consensus among the participants that most of the key questions about the noncompliance problem remained unanswered.

My role at the conference was to review the evidence on the overall size, growth, and composition of noncompliance in the United States. In the course of that review, I took a close look at the half dozen or so different approaches to measuring noncompliance that have emerged in the last 5 years, including those used by IRS. I was concerned not only to summarize and compare the alternative estimates, but also to evaluate their basic assumptions.

At the time I wrote the conference paper, only preliminary estimates were available from IRS's most recent study. These were originally presented to this committee in March 1982, by Commissioner Egger.[1] As I write this testimony, I have still not had a look at IRS's revised estimates, which I understand to be rather lower than its initial estimates. But I am told that the revisions, while significant, are mainly technical in nature, and that my major conclusions about IRS methodology still apply.

I will first summarize these conclusions and then make a few comments about their implications for policy research. Those who are interested in a more detailed discussion of these points and a review of other estimates of noncompliance will find both in my conference paper, a copy of which has been provided to the Committee.[2]

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[1] See "Statement of Roscoe L. Egger, IRS Commissioner," Subcommittee on Oversight, Senate Finance Committee, Mar. 22, 1982.

[2] See James S. Henry, "Noncompliance with U.S. Tax Law—Evidence on Size, Growth, and Composition," (ABA Section of Taxation: Invitational Conference on Income Tax Compliance, March, 1983). A version of this paper is to be published this fall by The Tax Lawyer and the Bureau of National Affairs.

WHY DO WE NEED NONCOMPLIANCE ESTIMATES?

Before I launch into a detailed critique of the IRS estimates, I will start with a simple question. What should we expect from such estimates—apart from satisfying the public's prurient curiosity about the underground economy? I suggest we should want to learn at least three things from them.

First, we want the estimates to provide an accurate and comprehensive description of the problem, including its size, growth, and composition. This should help us to:

Make sure that the overall problem is worth worrying about, relative to all the other tax policy issues on the agenda;

Identify the largest and most rapidly growing sectors of noncompliance for special policy attention; and

Check the accuracy of macroeconomic statistics like GNP and personal income, which depends heavily on tax administration data.

Second, we want the estimates to point toward *explanations* for observed trends in noncompliance, sorting out the influence of factors like changes in tax rates, enforcement policy, attitudes, and occupational structure. This should help us to:

Distinguish changes in compliance that are "purely technical" (e.g., a decline in the farm sector's relative size) from those that are "really worth worrying about."

Analyze the effects that specific policy changes might have on taxpayer behavior.

Anticipate future compliance problems and prepare for them.

Third, we would like such estimates to help us weigh the costs and benefits of new compliance policies. This means that we must understand not only the likely reactions of taxpayers to new compliance initiatives, as mentioned above, but also the likely public and private costs of achieving increased compliance.

Unfortunately, these three demands—for description, explanation, and policy evaluation—are not easy to satisfy all at once. The last two, in particular, require theoretical frameworks for understanding taxpayer behavior and the costs of tax administration. Even the first objective, while more purely empirical, is not straightforward, given serious problems with the available data, many different taxes, and important choices to be made with respect to what is considered "noncompliance" in the first place.

IRS' APPROACH TO COMPLIANCE ESTIMATES

How well have the latest IRS estimates met these three demands? In general, IRS's latest tax gap study is much more successful in satisfying the demand for description than it is in helping us either to explain noncompliance behavior or to evaluate specific policy alternatives.

MEETING THE FIRST OBJECTIVE—DESCRIBING THE PROBLEM

From the standpoint of describing the problem, the IRS's most recent study of noncompliance is a substantial improvement over its earlier efforts. The agency is to be applauded for having demonstrated a commitment to innovative research. Compared with its 1979 study of noncompliance,[3] there have been major methodological advances, including a greater awareness of the limitations of TCMP-based estimates, a clearer distinction between measures of overstatement and underreporting, a more critical attitude toward estimates of illegal-source income made by law enforcement agencies like the FBI and the DEA, and an effort to use information from new data sources, such as a household survey of expenditures on informal suppliers. This is significant progress and I believe that further such IRS research on compliance should be vigorously supported.

Despite such progress, there remains ample room for improvements in the IRS estimates at both a conceptual and an empirical level. As noted above, most of these improvements have to do with the fact that while the latest estimates do provide a helpful portrait of the overall noncompliance problem and a general idea of where new policy initiatives might be targeted, in their present form they are not really very useful for assessing the costs and benefits of specific policies or for understanding the factors that contribute to noncompliance.

From the standpoint of meeting the goal of accurately describing and scoping the problem, the most important areas for further improvement are as follows.

1. The definition of noncompliance used in the IRS's most recent study is in one sense so broad that it prevents us from forming a clear image of the problem. The

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[3] See U.S. Treasury, IRS, "Estimates of Income Unreported on Individual Income Tax Returns," (Washington, D.C.: September 1979).

study's "tax gap" measure embraces "all federal income taxes that are owed but not paid." This definition includes failures to file and late payments as well as overstated deductions, exemptions and credits, and understated gross income. Most important, it lumps together merely technical violations with negligent or willful wrongdoing. Since technical errors and violations can apparently be found on a very high fraction of returns by a determined auditor, and since the case of collecting the taxes owed by many small-time evaders presumably exceeds the benefits, this may be too inclusive. For example, the average amount of extra tax discovered per TCMP audit was just $99 per return in 1973 and $142 per return in 1976. Even for those taxpayers who actually underreported their income, the average amount of extra tax revealed per audit was just $395. Since TCMP audits are the most intensive, costly audits that the Service performs, this low average is perhaps more consistent with a "small, numerous, and only mildly dishonest" image of the typical noncomplier than it is with a "full-time professional evader" image. Such an image is also consistent with the fact that out of the roughly 50,000 detailed individual TCMP audits performed by IRS in 1979, only about 200 taxpayers were recommended for criminal prosecution.

It is important to stress that such a "nibbler" image of the cheating problem may be misleading, because it understates the role of professional evaders who, while relatively few, could account for a high share of misreported income. TCMP audits cannot be perfectly stratified to pick up such professional evaders without, in a sense, knowing who these people are in advance, and those who are truly expert at evasion leave faint audit trails anyway. As discussed below, there is indeed evidence that even the TCMP audit misses a large amount of underreported income. Of course it misses nonfilers completely.

Nevertheless, what is clearly desirable, but missing even from the IRS's latest estimates, is an analysis of the distribution of noncompliance amoung the taxpayer population. Understanding this distribution is absolutely crucial to our understanding of what can be done about the problem, a point to which I will return below.

The IRS's definition of noncompliance may also be very broad in another sense—it relies heavily on the TCMP auditors' initial assessments. Compared with the amounts that taxpayers ultimately have to pay at the end of an appeals process, such initial assessments are often very high. Evidence for IRS district audits as a whole indicates that for audit determinations that are appealed, only about a third of the initial dollar assessments are, on average, upheld.

So, if what we really want from our noncompliance estimates is a measure of "judicially-determined, willful tax cheating," we should remember that the IRS's definition of noncompliance casts a much wider net.

2. By including illegal-source income within the scope of its noncompliance definition, IRS has taken on a difficult measurement chore, with very mixed rewards.

From a legal standpoint, the inclusion of illegal activities like drug traffic and prostitution in the tax base is technically correct.[4] But from a policy standpoint, it really is most peculiar to speak of taxes lost because people fail to report activities that we prefer did not occur to begin with. If we were interested in maximizing the tax yield from illegal activities, presumably they would not be illegal in the first place. There is an interesting "tax gap" issue to be posed here, but it is not the one the IRS is asking. This is the question of how much tax revenue is foregone because such activities are not simply legalized and taxed.

Furthermore, since the evidence available to estimate illegal-source noncompliance is so intrinsically weak, and since the estimation methods required differ so much from one crime to the next, the inclusion of this sector greatly complicates the estimation task. IRS has implicitly acknowledged this by focusing only on a handful of major cash crimes like drug traffic, illegal gambling, and prostitution, leaving out such key ones as loan sharking, arson, fraud, bribery, embezzlement, trade infringements, counterfeiting, and the transfer of stolen property.

This is not to say that estimating the size and growth of the illegal sector has no useful purpose, but only that it may well not belong in a study of tax cheating.

3. From yet another angle, the IRS's definition of noncompliance is far too narrow. The IRS omits any consideration of noncompliance with state and local taxes, or federal payroll and exicse taxes. This is a key limitation, not only because the few studies done so far indicate that noncompliance with such taxes is a serious

[4] Precisely which measures of these activities should be included is, however, less clear. Section 351 of TEFRA disallows all deductions or credits for expenses incurred in narcotics traffic (for expenses incurred after Sept. 3, 1982). If illegal source noncompliance is included in our estimates, this provision would substantially increase the estimates after this date, since it effectively means that all gross revenue from illicit drug traffic is taxable.

problem, but also because payroll and excise taxes, in particular, are growing steadily in importance. Indeed, many families—especially those at the lower end of the income distribution—already pay more in employment taxes than income taxes. Rates of taxation for these "indirect" taxes are likely to continue their upward drift, so that by the mid-1980s the combined receipts from payroll and excise taxes at all levels of government will substantially exceed all income tax receipts. This raises the possibility that our future tax compliance problems may well be quite different from those addressed today by the IRS.

4. To arrive at its latest estimates, IRS leans very hard on a new approach to scaling up TCMP audit results that is largely untested and perhaps unreliable. If we compare the IRS's 1979 study with its most recent estimate, we find that for the same base year, 1976, the most recent total "tax gap" estimate is nearly twice as large as the earlier one. Most of this increase is due to a sharp upward revision in the IRS's figures for legal-source noncompliance—especially underreporting by individuals. This revision occurred because in the case of the most recent study the IRS simply multiplied all of the unreported legal source income discovered by the 1976 TCMP audit by a factor of 3.5. This factor was chosen on the basis of a 1977 study of information returns (IRP), which detemined that a taxpayer's true income is likely to greatly exceed the extra income discovered by a TCMP examiner unassisted by IRP documents. On the basis of this one study alone, the IRS increased its 1976 estimate of noncompliance nearly 100 percent. Estimates for subsequent years were similarly affected.

Unfortunately, the document study relied on by IRS was not precisely a model of statistical rigor.

The initial sample was actually a subsample of 1976 TCMP taxpayers, about 11,600 of the 50,000 in the original TCMP sample. Thus it was a "subsample of a sample," with large weights and relatively high coefficients of variation.

The subsample was selected by using an alpha letter method, rather than a purely random selection technique.

Only about 12 percent of those in the subsample were identified as owing additional tax. Since the cases had already been closed, the valuable feedback that an auditor normally receives when he confronts a taxpayer with possible errors was absent. The IRS planned to send notice letters to all of the 1,385 individuals found to owe added tax, but only about 785 such letters were ever sent. The other cases were closed on an estimated basis.

According to one IRS source, at least 5 percent of the group with a tax change had checksheets that contained errors.

In addition to these nits, there is also the more fundamental question of whether it really is appropriate to scale up TCMP audit results by using the same multiplier for all kinds of income. In the original IRP document study, for example, the actual multiplier for Schedule C income—one of the most important tax gap components—was only 1.4, yet the IRS applied the same 3.5 factor to this type of income.

One might well argue that the results of the IRP study were, if anything, conservative, since TCMP audits may be more accurate for IRP-covered types of income than for others. This is indeed the IRS's latest assertion. Where the truth lies, on balance, is now not very clear. What is clear is that we need another replication of the IRP study very soon to test the validity of the 3.5 multiplier as kind of a universal constant. We will probably discover that this multiplier is just as much subject to change as the voluntary compliance level itself. At the moment, however, we are stuck with the rather mechanical approach of multiplying each TCMP audit's results estimate by 3.5, an approach that is really no better than the TCMP audit itself from the standpoint of detecting trends in noncompliance.

MEETING THE SECOND AND THIRD OBJECTIVES—EXPLAINING THE PROBLEM AND WEIGHING NEW POLICIES

The problems just described basically had to do with the scope and accuracy of the IRS estimates. The problems we will turn to now are more fundamental. They have to do with the theory behind these estimates. There are at least two such problems, both of which severely limit the relevance of the IRS estimates to practical tax policy.

1. In the first place, the IRS's "tax gap" is what an economist might call a "partial equilibrium" concept, which is just a fancy way of saying that it is conditional on existing tax policies, labor market behavior, and public attitudes. In other words, the IRS tax gap measures the taxes that could be collected if, somehow, all hidden income were suddenly and costlessly revealed to the authorities, with all other be-

havior held constant. From the standpoint of practical compliance policy it is clear that such measurements are not really very meaningful.

For example, let us imagine that all economic activity suddenly becomes visible to the IRS. What would the likely increase in the tax base be? Whatever it might be, I suggest it would not be approximated by the IRS's measures of "tax gap." This is true for several reasons.

One reason is that in much of the underground economy, goods and services are priced below their formal-market, fully-taxed counterparts, precisely because of tax evasion. As a result, the incomes they generate are higher than if they were fully taxed. Thus the IRS's "tax gap" for these activities greatly overstates the likely revenue gain from taxing them.

Another reason is that for some workers, tax evasion has probably functioned as a substitute for reducing the supply of labor in response to rising marginal tax rates. If the IRS really did acquire perfect knowledge of everyone's income, as contemplated by the "tax gap" concept, this would have a negative impact on labor supply, reducing the total tax base below that implied by the IRS's partial equilibrium estimates. There would be similar effects on the supply of other factors like land, capital, and entrepreneurship, especially since our current estimates of noncompliance indicate that unreported rents interest, dividends, and partnership and proprietorship income are a large proportion of the total amounts of these types of income. Without a general equilibrium treatment of taxpayer behavior—taking into account such taxpayer responses to changes in compliance incentives—it is impossible to know what the practical tax gap really is.

A third reason that the IRS "tax gap" is an inacurrate measure of the tax revenue lost to noncompliance is that for illegal goods and services, complete observability would obviously be tantamount to the suppression of the trade. There would, for example, simply be no profits from the cocaine trade left around to be taxed. This makes the inclusion of the illegal sector's activities in the tax base for the purpose of estimating noncompliance look even more peculiar.

Our thought experiment--which assumed perfect IRS knowledge of everyone's income—also shows how misleading it is to consider compliance levels and tax gaps for different types of taxes in isolation from one another. Thus the impact of this sudden revelation on noncompliance for the tax system as a whole might well be much larger than a tax gap estimate based on federal income taxes alone would indicate. This is because any IRS policy that improves reporting and compliance for federal income tax purposes is also likely to improve compliance with state income taxes, employment taxes, sales taxes, and even foreign taxes.

2. The second basic conceptual problem with the IRS's "tax gap" estimates is that they fail to take into account the costs of achieving increased compliance. The IRS estimates, once again, refer to the taxes that would be due if unreported income and overstated expenses were somehow costlessly revealed to the authorities. But of course it is much more realistic to assume that improved compliance is costly, and that, indeed, at some point incremental improvements in compliance become more and more costly. The costs contemplated here include the audit, enforcement, and collection costs of tax agencies. They also include the time and out-of-pocket costs sustained by taxpayers in order to understand the tax code and meet its record keeping, reporting, withholding, and other requirements. Perhaps most important of all, they include the intangible costs of stiffer enforcement, most notably psychic costs like worry and anxiety, as well as intrusions on privacy and civil liberty. There is as yet little solid impirical evidence regarding these costs, especially the private ones. No doubt they are easily exaggerated in the heat of legislative battles. Clearly some are joint with other accounting activities. But at least for some taxes there is also no doubt that the total public and private compliance costs are huge, relative to the revenues collected. The IRS tax gap estimates, at best, address only the "revenue" side of this issue. They have nothing to tell us about whether the social costs of collecting the missing revenue might not be prohibitive. This severely limits their usefulness with respect to the evaluation of specific policy changes.

Recognizing that increased compliance costs as well as benefits has several implications that go beyond the interpretation of the IRS's noncompliance estimates. First, the achievement of absolutely perfect compliance is probably no more rational a policy objective than the reduction of environmental pollution or cocaine use to absolute zero. Second, in a mature tax system like ours we should expect that the cost of achieving increased compliance improvements with the standard withholding, audit, and enforcement tools may be rising steeply on the margin, since the easiest controls are already in place. Returns retrieval, audit selection, and document matching systems are already highly automated, and the withholding and information reporting requirements have already been extended to most income and

most third-party payments. Of course one can imagine new kinds of third-party reporting and withholding. But beyond these marginal improvements we enter a realm of noncompliance that is much less accessible to these traditional remedies. This is the realm of self employment; moonlighting; untraceable transactions in real estate and other capital assets; cash payments and checks made out to cash; foreign tax havens and false addresses; multiple Social Security numbers; pseudo- dependents; the skimming of small business receipts; complete nonfiling; and a host of other practices that are inherently difficult to detect and prevent. For these kinds of noncompliance the enforcement burden necessarily shifts to the use of detailed field investigations, informants, "stings", and other methods that have relatively high costs, both in terms of dollars and rights. To attack the remaining frontiers of noncompliance in a cost-effective way we may well need to supplement the traditional enforcement tools with other less orthodox remedies, including the mobilization of public opinion, the use of selective amnesty, and the reform and simplification of the tax code itself.

RECAPPING—THE NEW IRS ESTIMATES

Reviewing the highlights of our discussion, it turns out that the real noncompliance measurement challenge is not simply to come up with an estimate for misreported income at a given point in time, or the amount of tax that "might have been collected" on that income had it somehow been taxed—though even here, as we saw earlier, there are some thorny questions of definition and scope. The real problem is to understand precisely what such numbers are telling us. The IRS estimates reviewed here cannot be used to measure the potential benefits of more aggressive enforcement. They offer no theory of how taxpayer behavior might respond to stiffer enforcement, they ignore the social costs of increased compliance, and they provide tax gap calculations for illegal activities that are largely meaningless. Nor can we use them to indicate the impact of noncompliance on the distribution of income since they offer no evidence on how noncompliance is currently distributed.

Even more important, they shed little light on the question of what factors are responsible for the growth of noncompliance in the first place. Among the leading candidates are:

The impact of rising tax rates on incentives to cheat;

Changes in taxpayer attitudes toward government and the equity of the tax code;

Reduced audit and enforcement efforts, and a widespread perception that penalties for evasion have fallen;

Increased tolerance for "shaving" by clients among tax preparers; and

Changes in economic structure and payment systems that have facilitated cheating.

As noted earlier, many activities on the frontiers of noncompliance may be beyond the reach of traditional enforcement, reporting, and withholding remedies. Until we know more about the relative importance of the factors responsible for noncompliance, it will be difficult to find substitutes.

NEXT STEPS—NONCOMPLIANCE RESEARCH

What does this discussion suggest about the next steps for noncompliance research? The following areas seems to be most in need of immediate attention.

First, it is crucial for the implications of the 1977 IRP document study to be tested as soon as possible. In fact there should probably be regular checkups on the ability of IRS audits—TCMP or ordinary—to detect misreporting.

In so far as legally permissible, IRS should be encouraged to conduct more frequent, smaller, in-depth taxpayer surveys as a supplement to the TCMP, which is really designed more for operational purposes than for noncompliance research.

We need to understand the size distribution of both the noncompliance detected by TCMP and the additional underreporting thrown in by the IRP study multiplier. This would begin to tell us how much of what we call "noncompliance" really involves large-scale tax fraud and how much of it is just nibbling.

We should aim for "general equilibrium" tax gap estimates, which take into account the response of compliance levels to changes in enforcement incentives, rates, and other factors.

There is still a great deal we need to know about the costs of compliance in order to determine the policy implications of noncompliance estimates. In particular, we need to measure the costs born by individuals and businesses to comply with alternative reporting and withholding systems.

We need to understand the role played by tax preparers in the compliance process. This is especially important, not only because of the high share of all individual

tax returns prepared by paid preparers—now about 40 percent—but also because there is at least some evidence that such returns have lower compliance levels.[5]

Finally, and perhaps most important, we need to supplement our estimates of size, growth, and composition with a much better understanding of the factors—tax rates, attitudes, sanctions, and so forth—that are responsible for the size, and composition of noncompliance.

I wish to thank the committee for this opportunity to appear. I would be glad to submit more detailed responses to any specific questions the committee might have.

The CHAIRMAN. I think we can maybe hear one more witness. I need to go back and vote again. Mr. Aidinoff, maybe we can hear your statement, which has been made a part of the record. If you could summarize, that would be helpful.

STATEMENT OF M. BERNARD AIDINOFF, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. AIDINOFF. Mr. Chairman, I appear on behalf of the section of taxation of the American Bar Association.

The American Bar Association has established a commission on taxpayer compliance to develop and supervise a long-range research program on the nature, categories, and causes of noncompliance. This will be conducted by the American Bar Foundation. Hopefully we will be able to come up with some of the answers to the questions Mr. Henry has asked. In fact, we are using him as one of our consultants.

In this connection I urge your committee and the Congress to vote additional resources to determine more about causes, because without that knowledge it is very difficult to discuss the subject.

Despite our current general lack of knowledge about the causes of noncompliance, one thing is clear: Our tax system works best when it is least voluntary—that is, all of the public and private studies of our Federal tax system indicate that compliance is highest in areas in which withholding a tax is mandatory. It was for this reason that Congress less than a year ago, in enacting the compliance provisions of TEFRA, imposed withholding on interest and dividend income.

While it may seem somewhat late to make this comment, there are a substantial number of tax professionals, as well as ordinary citizens, who believe that withholding on dividend and interest income is substantially more effective than information reporting, and that it is a disservice to those of us who report all of our income not to have withholding on such income. It was for this reason that the section of taxation of the ABA recently voted overwhelmingly to recommend that Congress leave in place a system of withholding on interest and dividends.

The CHAIRMAN. I think that was about 6 months too late.

Mr. AIDINOFF. Unfortunately, we do not have the resources to write the number of letters and postcards that other organizations do.

The CHAIRMAN. Well, if you don't pay taxes you have a lot of resources.

Mr. AIDINOFF. However, if we are not going to have an all-inclusive withholding system, it is extremely important that we have

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[5] Admittedly this may simply reflect the fact that returns submitted by preparers are typically more complex than those filled out by taxpayers themselves.

better information reporting, that more resources be devoted to enforcement, and that increased penalties be imposed on those who fail to report dividend and interest income.

One of the major possible causes of noncompliance is the complexity of our tax laws and the inclusion of special provisions which only high-income taxpayers can utilize. Unfortunately, there has been a growing perception that the wealthy do not pay their share of taxes, since they take advantages of important provisions in our code which permit sheltering. This perception has caused many ordinary taxpayers to fashion their own illegal shelters, which take the form of moonlighting for cash which they do not report, failure to report dividend and interest income because of the belief that others don't, and to some extent taking fictitious deductions because others supposedly do so.

Unfortunately, more and more ordinary taxpayers have lost their respect for our tax system, which in turn breeds more noncompliance.

One of the results of taxpayer dissatisfaction has been the increased willingness of taxpayers to invest in tax shelters. Congress has made a number of changes which have dealt with this problem. In 1981 you added numerous new penalty provisions affecting not only taxpayers but promoters of tax shelters and advisers. The new penalty on substantial understatement of tax liability should discourage investment in borderline shelters. Similarly, the partnership audit provision should help substantially. The advantage of the interest play has been eliminated.

The stiffer civil and criminal fraud penalties hopefully will reduce the more flagrant provisions in the abusive tax shelter area.

I would like specifically to note that the recent congressional administrative changes have increasingly placed the professional tax adviser in the role of assisting the IRS in the compliance process. This is certainly the effect of the tax return preparer penalties and is also the effect of the overevaluation and substantial understatement penalty.

As you know, the backbone of compliance with our Federal tax laws is the examination and collection function. It is regrettable that audit coverage has decreased while noncompliance has increased, and on behalf of the section I would like to urge this committee and the Congress to do as much as it can to support increased resources, not only for the Internal Revenue Service but for the tax collector.

The CHAIRMAN. Thank you very much. I had better run over and vote, and I will be right back.

[The prepared statement follows:]

STATEMENT OF M. BERNARD AIDINOFF, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

I am M. Bernard Aidinoff of New York, New York. I presently serve as Chairman of the Section of Taxation of the American Bar Association. I appear on behalf of the Section of Taxation and its 26,000 members.

In announcing this hearing, Chairman Dole indicated a desire to discuss possible measures to reduce the $100 billion annual tax compliance gap. Recently, the Section of Taxation sponsored an invitational conference on income tax compliance which was attended by approximately 130 invitees. Participants included not only tax lawyers and law professors, but economists, criminologists, sociologists, histori-

ans, accountants, present and former government officials, foreign tax officials, and state and local tax officials. The purpose of the conference was to discuss the extent, nature and causes of noncompliance with our Federal tax laws and to analyze ways in which conventional and new techniques might be used to reduce noncompliance. In addition, the American Bar Association has established a Commission on Taxpayer Compliance to develop and supervise a long-range research project on the nature, categories and causes of noncompliance with our Federal tax laws to be conducted by the American Bar Foundation. I therefore welcome the opportunity to discuss with your Committee ways in which we can strengthen and support our tax system and reduce noncompliance with our tax laws.

In this connection, I urge your Committee and the Congress to devote additional resources and attention to determine more about the causes of increasing noncompliance with our Federal tax laws. Without additional information about the causes of noncompliance, it is difficult to discuss intelligently measures to reduce noncompliance and encourage compliance with our tax laws.

Despite our current general lack of knowledge about the causes of noncompliance, one thing is clear: our tax system works best when it is the least voluntary. That is, all of the public and private studies of our Federal tax system indicate that compliance is highest in areas in which withholding of tax is mandatory. Your committee put it best when, less than a year ago, it stated: "The Internal Revenue Service estimates that 15 percent of dividend income and 22 percent of interest income is not reported by taxpayers. In contrast, 99 percent of wage income is reported by taxpayers. The Committee believes that the difference in compliance rates is best explained by the fact that wages are subject to withholding but interest, dividends, and patronage dividends are not."

It was for this reason that this Committee and Congress less than a year ago, in enacting the compliance provisions of the Tax Equity and Fiscal Responsibility Act of 1982 [TEFRA] imposed withholding on interest and dividend income. While it may seem somewhat late to make this comment, there are a substantial number of tax professionals as well as ordinary citizens who believes that withholding on dividend and interest income is substantially more effective than information reporting and that it is a disservice to taxpayers who report all their income from all sources not to have withholding on such income. Unfortunately, the repeal of withholding on interest and dividends may signal many taxpayers that Congress is not sincerely interested in reducing the level of noncompliance with our tax laws. It is difficult for the American taxpayer to understand how Congress could have concluded that withholding on interest and dividends was imperative in 1982 and yet less than a year later repealed the withholding provision. It was for this reason that the Section of Taxation of the American Bar Association recently voted overwhelmingly to recommend that Congress leave in place a system of withholding on interest and dividends. If we are not going to have an all-inclusive withholding system, it is extremely important that we have better information reporting, that more resources be devoted to enforcement programs, and that increased penalties be imposed on those who fail to report dividend and interest income. Hopefully, some of the provisions embodied in the Senate amendments to the interest and dividend withholding repealer will survive conference.

One of the major possible causes of noncompliance is the complexity of our tax laws and the inclusion of special provisions which only high-income taxpayers can utilize. Unfortunately, there has been a growing perception that the wealthy do not pay their share of taxes since they can take advantage of important provisions in our Code which permit the sheltering of substantial amounts of income. This perception has caused many ordinary taxpayers to fashion their own illegal shelters which take the form moonlighting for cash which they do not report, failure to report dividend and interest income because of the belief that others do not report such income, and, to some extent, taking fictitious deductions because others supposedly do so. Unfortunately, more and more ordinary taxpayers have lost their respect for our tax system, which in turn breeds more noncompliance. As pointed out recently by one Washington columnist: "I note nowadays among respectable suburbanites very little disapproval of outright evasion of taxes, as well as a willingness to pay the plumber in cash. The view spreads that sins involving taxes, like amorous indiscretions, are private matters and really more to be envied than condemned. Unless something is done (and nothing will be) voluntary compliance will soon be like the wooly mammoth, of which there aren't any." Fred Reed, the Washington Times June 13, 1983.

One of the results of taxpayer dissatisfaction has been the increased willingness of taxpayers to invest in tax shelters.

Legitimate tax shelters reduce tax liability by (1) leverage that produces tax losses through increased depreciation of assets purchased with borrowed funds; (2) conversion of ordinary income into capital gain, or of short-term capital gain into long-term capital gain; and (3) the use of accelerated depreciation and current expensing to defer tax liability. Opportunities to use these techniques in legitimate tax shelters have been substantially reduced in recent years by introduction of at-risk concepts and modification of other substantive areas, such as the treatment of interest during construction. As Congress has acted to reduce the use of these benefits in legitimate tax shelters, tax shelter promoters have responded by introducing more exotic and borderline tax reduction arrangements.

In response to the rise of increasingly abusive tax shelters, Congress has made a number of changes in the tax laws. By reducing marginal tax rates, Congress has reduced the marginal utility of tax shelters to many taxpayers. In 1976 Congress added provisions to penalize and enjoin incompetent and abusive tax return preparers. In 1981, Congress added numerous new penalty provisions affecting not only taxpayers, but promoters of tax shelters and advisers. The new penalty on substantial understatement of tax liabilities should discourage investment in borderline shelters. The authority to seek injunctions against promoters of abusive tax shelters should also be useful. The partnership audit provisions should considerably aid the Internal Revenue Service and the Tax Court in handling tax shelter cases. The advantages of the interest play previously available with respect to faulty tax shelters has been eliminated through the new interest compounding provisions and through additional penalties. The stiffer civil and criminal fraud penalties hopefully will reduce the more flagrant violations in the abusive tax shelter area. These are desirable new provisions. In my opinion, this is not the time for further legislation but a time to utilize these new tools to see whether they will work. Hopefully, they will reduce the attractiveness of borderline tax shelters.

I would like to specifically note the recent Congressional and administrative changes which have increasingly placed the professional tax adviser in the role of assisting the Internal Revenue Service in the compliance process. This is certainly the effect of the tax return preparer penalties, and it is also the effect of the overvaluation and substantial understatement penalties. Hopefully, the substantial understatement penalty will eliminate reasonable basis opinions and cause taxpayers to take positions only if they are supported by substantial authority and a belief that thet are in fact entitled to the claimed tax treatment. In addition, recent proposed revisions to the Treasury Department's Circular 230 incorporate much of Opinion 346 of the Standing Committee on Ethics and Professional Responsibility of the American Bar Association, which sets forth the standards and ethical considerations which should be applicable to opinions by lawyers analyzing the tax effects of an investment in a tax shelter offering. Responsible members of the tax bar have the same interest as the members of this Committee and the Internal Revenue Service in curbing the use of abusive tax shelters. Our tax system can only work if the public has respect for it, and those of us to whom the public looks for tax guidance should be willing to demonstrate our respect for the tax laws through compliance with these new rules.

As this Committee knows, the backbone of compliance with our federal tax laws is the examination and collection functions of the Internal Revenue Service. it is regrettable that as noncompliance has increased, audit coverage of taxpayer returns has decreased because of increasing demands and declining personnel in the Internal Revenue Service during the last decade. On behalf of the Section of Taxation I strongly urge this Committee and Congress to support increased resources for the Internal Revenue Service and for the Tax Court.

Finally, willful, criminal noncompliance can only be handled by vigorous enforcement of our criminal tax laws and the assertion of civil fraud penalties, with adequate publicity being given to prosecutions in this area. Of course, how much can be done in this area is dependent upon the Internal Revenue Service having the machinery and resources to find the illegal conduct and the ability of the Justice Department to prosecute these cases. These abilities are very much dependent upon our enforcement agencies having the necessary financial resources, and I urge this Committee and Congress to provide those resources.

Thank you for permitting me to testify today. I will be happy to answer any questions that the committee may have.

Underreported Taxable Income: The Problem and Possible Solutions

Federal Taxation Division

JANUARY 1983

AICPA American Institute of Certified Public Accountants
1620 Eye Street, N.W., Washington, D.C. 20006

INTRODUCTION

The intentional underpayment of taxes is certainly not a new phenomenon. It has been a common problem since biblical times. The scope and magnitude of the problem have varied from time to time and from country to country, but underpayment has been a serious concern for centuries. The citizens' attitudes and their inclination to underpay can vary from one type of tax to another. For example, within the United States the high level of noncompliance with the personal property tax has caused many jurisdictions either to abolish or modify that system; however, during this same time span there has been a high degree of voluntary compliance with the self-assessed income tax.

Since World War II, however, voluntary compliance in the United States has deteriorated, and during the past ten or fifteen years this unfortunate development has reached serious proportions. Various studies indicate that the federal tax shortfall due to the underreporting of income may be as high as $70 billion to $120 billion. If such amounts were collected in full, the federal budget could be balanced and/or tax rates could be decreased significantly. This situation presents a serious equity issue: The honest taxpayers are bearing an ever-increasing burden because of the growing number of citizens who are not paying their full tax. This can easily become a self-perpetuating cycle. As the honest taxpayers' burden increases, the growing inequity of the situation may convince them that they are

paying an unfair share. This, in turn, could motivate more of them to join that segment of society that is not paying what the law requires, and might ultimately lead to the breakdown of the voluntary compliance system itself.

In addition, if the situation continues to worsen, it could lead to the disruption of our economy and even to a breakdown in society if Congress finds itself unable to raise sufficient revenue. In all likelihood, if the situation threatens to approach such proportions, Congress will feel compelled to adopt a system quite different from the self-assessment system we have enjoyed for so many years.

The Federal Tax Division of the American Institute of CPAs has recognized that CPAs have valid reasons to be concerned about this situation. Accountants are concerned with the growing inequities among citizens and have a professional interest in maintaining the viability of the voluntary compliance system.

This report addresses the terminology and scope of the problem, the nature of underground income, possible causes of underreporting, the situation abroad, public opinion, and possible ways to alleviate the problem. An extensive bibliography and a list of references include citations to significant articles, books, and special studies related to the underground economy. The parenthetic numbers in the text refer to the corresponding items in the list of references.

SUMMARY OF RECOMMENDED ACTIONS

While it is recognized that underreporting of income will never be completely cured, this report suggests several specific actions that could help alleviate the inequities and contain the growth of the underground economy. The areas of concern, types of recommendations, and some of the specific suggestions are outlined below.

Enforcement activities

- o The IRS should redirect some of its efforts toward the underground economy.

Penalties

- o Current penalties for both civil and criminal fraud should be reexamined.

Informational reporting

- o Reporting should be extended to include business payments to corporations, transactions with barter exchanges, auction houses, dealers in collectibles, and large currency transactions.
- o Tax returns should be modified to provide more information and to ease matching with informational forms.

Withholding should be required on —

- o Business payments to independent contractors.
- o Interest and dividend payments. (The government should bear the administrative burden or the cost thereof.)

- o Taxable pension payments.
- o State tax refunds.

Currency reform

- o Encouraging the use of checks and credit cards and discouraging the use of currency might deter transactions that are common to certain facets of the underground economy.

Tip income

- o A special conference should be held to explore new and innovative approaches to this perplexing problem area.

Education programs

- o It is probable that some taxpayers underreport income because they do not understand that —
  - The income is taxable.
  - The risk they are running by underreporting is significant.
  - Their actions have consequences for the economy and the country.
- o The IRS should expand and improve its educational efforts.
- o Some educational efforts would have greater credibility and acceptance if provided by groups outside the government.

Therefore, the AICPA should seek to enlist the support of other organizations in an effort to conduct an extensive national education program.

TERMINOLOGY AND SCOPE OF THE PROBLEM

Several labels have been coined for that part of the economy that consists of income concealed from the tax collectors. The most common seems to be "underground economy"; authors have also used "subterranean," "clandestine," "irregular," and "hidden" economy. The Internal Revenue Service has subdivided the area into the "illegal economy" and the "informal economy." Illegal describes the underlying transactions and includes prostitution, gambling, drugs, extortion, embezzlement, and the like. In the informal economy, the activities are legal but are not reported properly, or not reported at all, for tax purposes.

The charge to the Task Force was to examine only the informal segment of the underground economy to determine how the accounting profession could assist in alleviating the problem and what additional measures the government or others could take to improve compliance with the income tax statutes.

We have not attempted to measure the dollar volume of the underground economy. The several studies that undertook that task have shown widely varying results, but all of them indicate that the problem is serious enough to deserve the attention of CPAs and other responsible citizens.

The earliest relevant study was reported in 1977 by Peter M. Gutmann, an economist from Baruch College of the City University of New York (11, 12, 13). He estimated that approximately $176 billion in income was going unreported in 1976, approximately one third of it from illegal activities and the other two thirds from the informal

economy. Gutmann's estimates were based on an examination of the stock of money (M1), composed of currency plus demand deposits. Gutmann stated that from 1937 to 1941 the underground economy was small. Using that base period, he found that currency averaged $217 per $1,000 of demand deposits. Gutmann then determined that by 1976 currency in circulation had reached $344 per $1,000 of demand deposits (an increase of $127 per $1,000, or 36.9 percent). Gutmann therefore inferred that of the $77.8 billion in circulation in 1976, 36.9 percent, or $28.77 billion, was used to fund the underground economy. The other $49.1 billion of currency in circulation, plus the $226.2 billion of demand deposits, made up the total money supply in the regular, reported economy. The total money supply of $304 billion supported a GNP of $1,869 billion. Gutmann therefore concluded that the $28.7 billion was supporting an unreported economy of $176 billion.

Gutmann noted that currency held abroad, or used to store ill-gotten wealth, is not subtracted before estimating the unreported GNP. Furthermore, on the basis of the $176 billion generated in the underground economy, Gutmann estimated that up to 1.6 million more workers may have been employed than were reflected in official statistics. In a later study, he revised this estimate to 5 to 6 million workers who are employed only in the underground economy (10).

In 1978 Edgar L. Feige, an economist from the University of Wisconsin, estimated the underground economy at $400 billion (7, 8). Feige questioned Gutmann's assumptions relating to the base period chosen, an unchanging ratio of currency to demand deposits, the use of

currency as the exclusive medium of exchange in the underground economy, and the same amount of GNP generated by reported and unreported dollars. Instead, Feige used the sum of all transactions to estimate total macroeconomic activity. The ratio of total transactions (using the estimated life of circulating currency) to observed income was determined. The ratio for the benchmark year, 1939, was used to estimate GNP without an underground economy. The difference between the estimated and actual GNP produced Feige's approximations of the underground economy.

As with Gutmann, some of Feige's assumptions are questionable: the choice of an appropriate base year, the assumed nonexistence of an underground economy in 1939, the relative income velocity in the irregular and regular economies, the estimates of turnover rates of demand deposits and currency, and the exclusion of barter transactions from the estimates.

Gutmann and Feige used entirely different methodologies, yet each estimated that the underground economy was growing two or three times faster than the regular economy. Both men revised their estimates in 1981, raising them to $420 billion and $800 billion, respectively. These estimates suggest that as much as 10 to 25 percent of GNP may be unreported.

Moreover, since these amounts are excluded from national income statistics, it is apparent that many of the widely followed macroeconomic measurements are erroneous, and the judgements based thereon may be misleading. Such measurements as national income, GNP, unemployment, and inflation are seriously misstated, because they do not take into

consideration the underground economy. Yet many government and business decisions are based upon those numbers, including the automatic indexation of social security benefits, many wage contracts, changes in the money supply, and various social programs.

In 1979, the IRS published the results of a special study of 1976 incomes (14). The IRS estimated that individuals had failed to report approximately $135 billion of income in 1976. Of this, about $100 billion was income from legal sources, which should have produced some $17 billion of income tax. The report, quite appropriately, pointed out that during the same year individuals did report $1.73 trillion of income and paid $142 billion in taxes. Thus, it was estimated that in 1976, 92.6 percent of income from legal sources was reported. The IRS estimated the unreported amount of legal income from various sources as follows:

Individual Income 1976

(Dollar amounts are shown at the midpoint of ranges estimated by the IRS.)

	Billions of Dollars		Percent
	Reported	Unreported	Unreported
Salaries and wages	$ 881	$ 24	2.6%
Dividends and income from subchapter S corporations	25	3.5	12.3
Interest	49	6.5	11.7
Capital gains	19	4	17.4
Self-employment	60	36	37.5
Rents and royalties	6	4.5	42.9
Pensions, annuities, estates, and trust	27	5	15.6
Other	7	2.5	26.3
Totals	$1,074	$ 86	7.4%

This table indicates that in all categories other than salaries and wages, $193 billion was reported, but $62 billion, or 24.3 percent, was not reported. When this 24.3 percent unreported is compared to the 2.6 percent of salaries and wages unreported, it is easy to see the significant effect of withholding. As would be expected, some of the above estimates are more reliable than others. Jerome Kurtz, at that time commissioner of internal revenue, indicated to our task force that the interest and dividend figures were quite firm, whereas the self-employment estimate was rather soft.

These estimates were derived from several data sources. The Taxpayer Compliance Measurement Program (TCMP) provided information on the nature and extent of compliance, using stratified random sampling of returns filed. Discriminant analysis was employed to divide taxpayers into ten classes, each of which had a distinct compliance profile. Selected returns were examined for compliance, and data were weighted appropriately to obtain summary statistics. Data on nonfilers were obtained from the Exact Match File (23), which had been developed from interviews of 50,000 households. This program was directed toward nonfilers having substantial tax due, and thus did not include nonfiling taxpayers with smaller incomes. Other information from a file on employee compensation permitted estimation of the amount of nonfiler wage income. Total income received by individuals was compared with total income reported on tax returns using macroeconomic data from the Bureau of Economic Analysis.

In the previous table, no attempt was made to distinguish between underreporting and nonfiling because of the limitations of the data.

These sources provided only the beginning points for many of the estimates made in the study. As noted earlier, some types of information are more reliable than others. For example, information on income subject to withholding is of a higher quality than that on rents and royalties.

Some preliminary figures on the "Gross Tax Gap" were released in March 1982 as part of Commissioner Roscoe Egger's statement before the Senate Finance Committee's Subcommittee on Oversight of the Internal Revenue Service. These figures are included here to illustrate the growth in the underground economy. It should be noted that these 1982 figures report unpaid taxes, whereas the 1976 table reflects unreported income. The 1982 report covers income tax only and does not include social security or unemployment taxes, which would undoubtedly be large amounts. The 1982 study also covers the illegal sector for which the estimated tax gap was in the range of $6.1 billion to $9.8 billion in 1981.

Some reports issued during the fall of 1982 indicated that the earlier measures of the informal economy might have been substantially overstated. However, as stated before, we have not attempted to measure the magnitude of the underground economy nor do we endorse the methodologies or results of any of the studies. All of the studies indicate that this is a serious problem that needs prompt attention.

Gross Tax Gap From Individual Income Tax Returns Filed, Nonfilers, and Corporate Tax, Tax Years 1973, 1976, 1979, and 1981

	Amount of Tax Gap (Billions of Dollars)			
	1981	1979	1976	1973
Individual Tax				
Tax loss from underreported income:				
Wages	$ 2.5	$ 1.8	$ .7	$ .6
Tips	2.3	1.7	1.4	.9
Dividends	3.6	3.1	1.5	.9
Interest	4.1	2.9	1.3	.9
Capital gains	9.1	8.5	5.1	2.0
Nonfarm business	26.2	17.5	11.6	9.6
Farm business	1.4	1.7	1.7	1.5
Pensions	2.8	2.3	1.1	.7
Rents	1.5	1.2	.6	.4
Royalties	1.3	.8	.4	.1
Partnerships	5.5	3.1	2.5	1.5
Estates and trusts	.5	.4	.3	.2
Small business corporations	1.7	1.2	1.2	.4
State income tax refunds	.4	.3	.1	.1
Alimony	.1	*	*	*
Other	3.1	2.4	1.0	.6
	$66.1	$49.0	$30.6	$20.5
Tax loss from overstated deductions, and credits**	$12.3	$ 9.4	$ 6.2	$ 4.8
Nonfilers**	4.9	3.4	2.2	1.2
Total individual tax gap	$83.3	$61.8	$39.0	$26.5
Corporate Tax**	3.9	4.7	3.6	2.8
Total tax gap from legal sector	$87.2	$66.5	$42.6	$29.3

*Less than $100 million

**These are preliminary IRS figures and have not been reviewed by the Office of Tax Analysis.

Note: Details may not add to totals because of rounding.

THE NATURE OF UNDERGROUND INCOME

It is clear that some types of income are more easily understated or omitted from a tax return than others. Thus, the underground economy thrives on income not subject to withholding or to informational reporting. Currency transactions are easier to hide from the tax collector than business conducted with checks. Both currency and checks are more susceptible to underreporting than are credit card transactions. Barter transactions bypass all records—currency, checks, and credit cards—and are the most difficult to detect.

A barrage of articles in the popular media have identified a wide variety of underground activities, ranging from the very small to the very large, such as—

- Skimming, including businesses that simply fail to record some of their cash sales, cab drivers who leave a few fares off the trip sheet, and merchants who take home television sets and write them off as shoplifting.
- Tips that are pocketed tax-free.
- Domestic help paid in currency.
- Wage earners who moonlight in second jobs and are paid in currency.
- Building tradesmen or auto mechanics who do extra jobs on their own time.
- Professionals who exchange services.
- Business travelers who "pad" expense accounts and do not report reimbursements as income.

- Unemployed workers or social security retirees who do odd jobs for cash while drawing benefits.
- Taxable use of business property and other taxable perquisites of business executives.
- Income that is paid directly into a foreign bank account.
- Garage sales and flea markets.
- Arts and crafts sold by the maker.
- Exchanges of goods or services through one of the many barter clubs or barter exchanges that have sprung up in recent years.

A number of articles in the popular media reveal a lack of understanding of the tax law and the tax system. Some writers fail to distinguish tax avoidance from tax evasion. They appear to condemn all wealthy taxpayers and businesses who avail themselves of the tax incentives intended by Congress to encourage precisely those activities in which the businesses are engaged. A Washington Post article, (18) included as an underground activity any business incorporated in a Caribbean tax haven to avoid U.S. taxes. While such articles may be inappropriate and unfair, they may indicate a public perception that is nurturing the underground economy. The belief that big businesses and the wealthy are avoiding taxes may influence individuals to rationalize their own do-it-yourself tax loopholes.

Some of the underground activities listed previously can produce cash with little or no taxable income. For example, garage sales are often mentioned as part of the underground economy; however, the sale of furniture, clothing, and other household items seldom gives rise to a recognized gain. Other than relatively valuable items—such as

jewelry, sterling silverware, antiques, or art objects—few personal assets are likely to be sold for a price in excess of their original cost. Even in underground sales where the transaction is of a taxable nature, the taxable income is not the full cash received but only the excess over the adjusted basis of the property sold. While the sale of certain items may result in taxable gain, the sale of others may result in nondeductible losses. This generates a perception of unfairness that may cause some gains to go unreported.

Another segment of the underground economy that may not generate much taxable income includes part-time work and work for very low wages. The allowable exemptions and the standard deduction have increased the tax threshold to a point where much of the income from part-time student help, domestic workers, migrant workers and other farm employees, and many tips would not create a tax liability. The underreporting of such income is not to be condoned, but its importance must be viewed in perspective to the total underground economy. This is not to suggest that all small amounts be ignored. Small amounts on many returns can add up to significant revenue losses for the government.

Bartering

Bartering presents especially troublesome enforcement problems and may be one of the most rapidly growing areas in the underground economy. It covers a wide range of transactions—from neighbors exchanging baby-sitting or other favors, to doctors and dentists trading their professional services, to airlines exchanging otherwise

unused spaces on planes for otherwise unused rooms in hotel chains. A relatively new phenomenon, the barter exchange allows individuals or corporations to provide merchandise or render services in exchange for bookkeeping credits. Those credits can be used at a later time to obtain any of a wide variety of goods or services advertised in the barter exchange catalog.

Bartering presents economic and accounting issues, as well as income tax problems. There are unresolved questions about the definition of income and about timing and valuation. Services exchanged among family, friends, and neighbors are probably gifts and therefore not subject to tax. In a direct exchange, the timing is certain although the valuation may not be. The Internal Revenue Code stipulates that income received in a form other than cash is to be reported at fair market value. But, this is often difficult to apply. What is the fair market value of a large block of otherwise unused space on several hundred airline flights? In a direct exchange between two parties, the valuation problem is often somewhat alleviated because value may be more readily apparent on one side of the transaction than on the other. However, the organized barter exchanges may exacerbate the valuation problem by postponing one side of the transaction.

Transactions through a third-party barter exchange also give rise to some technical timing problems. The basic question is whether gain should be recognized for tax purposes when credits are received from the barter exchange or at some later date when actual goods or services are received for those credits. An accrual-basis taxpayer would report income at the time the services are rendered or the merchandise

delivered. A cash-basis taxpayer, on the other hand, might reasonably expect to report income when goods or services are received. It is not certain that barter credits will ever be exchanged for goods or services, and typically there is no provision for refund for unused credits. Nevertheless, the IRS has ruled that barter exchange transactions are taxable at fair market value at the time that goods or services are rendered in exchange for credits (19).

POSSIBLE CAUSES OF UNDERREPORTING

By definition, the underground economy is susceptible neither to precise measurement nor to definitive analysis. Although it is difficult to discern exactly why more and more people are participating in the underground economy, several contributing factors can be identified.

1. The combination of high tax rates and high inflation can cause taxpayers to find themselves with a lower real income, yet a higher tax bill. Otherwise law-abiding taxpayers may reason that their tax burden has risen above their "fair share."
2. The increasing complexity of the tax law can erode public confidence that the tax law is treating everyone fairly. The uneasy, perhaps even subconscious, feeling that others are escaping tax can be used as a rationalization for cutting a few corners.
3. Closely related to, and a substantial cause of, the complex tax law is the use of the Internal Revenue Code to motivate or impede certain social and economic activities. What Congress intends as a tax incentive may be perceived as a tax loophole by some who are not in a position to utilize that particular provision. The perception that Congress is intentionally allowing wealthy taxpayers and big business to escape taxes legally can be a strong motivation for others to create their own tax savings.

4. The increasing media attention to this problem may turn into a self-fulfilling prophecy. It becomes easier to rationalize tax cheating on the grounds that "everyone else is doing it."
5. The changes in social mores and general morality that have been evident in many walks of life also have had an impact in the tax arena. Many people seem to have less confidence in, and respect for, many of society's institutions, including government, the church, universities, big business, and big labor. There is a growing feeling that it is acceptable to ignore "unfair" laws.
6. There is a growing perception that the IRS enforcement practices are applied in an uneven and inequitable fashion, whereby low- and middle-income taxpayers are harassed over small amounts, while insufficient attention is paid to the wealthy and especially to nonfilers.
7. Increasing government rules and regulations and payroll taxes provide motivation for many businesses to keep employees off the books.
8. A perception—whether correct or not—of widespread waste and inefficiencies in government is often used by some to justify their underreporting.
9. There may well be a lack of understanding on the part of many taxpayers as to —
   - o The fact that underground types of income are taxable.
   - o The risk involved in the failure to report fully.
   - o The serious impact the underground economy can have upon society in general.

EXPERIENCE ABROAD

The underground economy is not a phenomenon exclusive to the United States. It seems to thrive in many, perhaps all countries, regardless of their political or economic systems.

The largest underground economy is believed to be Italy's l'economia submersa, which has been estimated at 30 to 35 percent of the regular economy, or $43 billion (3). Feige states that the underground economy is smaller in Scandinavian countries, where there is a "social contract" between the government and the citizens, than in Italy, where "respect for authority has been crumbling for centuries" (7). Nevertheless, Sweden is estimated to have a secret economy equal to 10 percent of the national product and a loss of tax revenue equal to 15 percent of the budget (3).

France's travail au noir, may constitute 25 percent of the official economy. West Germany's Schwarzarbeit may equal $25 billion in untaxed labor income and $4 billion in lost tax revenues, in addition to uncollected payroll taxes. Britain's fiddling was estimated to be 7 to 8 percent of the national output in 1979, but may now be as much as 15 percent. Less than 10 percent of Thailand's 19 million workers file tax returns, and up to 40 percent of all Argentine business is involved with morocho, or the black money market (3, 17). These statistics indicate that the underground economies abroad are at least as large as in the United States. The problem in Europe has been deemed serious enough for the Organization for Economic Cooperation and Development (OECD) to authorize a study of the legal and administra-

tive provisions pertaining to tax avoidance and evasion in member countries (16).

The reasons given for emergence of sizeable underground movements abroad include —

- o High tax rates or steeply progressive tax schedules.
- o The combination of high tax rates, budget deficits, and inflationary pressures.
- o The high percentage of cash transactions. (One half of Britain's labor force is paid in cash.)
- o The large percentage of workers in agriculture, an activity that traditionally has been kept off the books. (Extensive moonlighting has been a tradition in France.)
- o Deep distrust of government.
- o Government inefficiency.
- o High labor costs, which encourage firms to keep employees off the books to avoid payroll and unemployment taxes.
- o Honest businessmen's feelings that they must join the underground in order to remain competitive.

The number of workers engaged in moonlighting and regular jobs kept off the books continues to expand as individuals and firms struggle to meet inflated costs of living and business expenses. Perhaps 5 percent of Europe's labor force and one third of Italy's (65 percent of the government employees and teachers) are involved in secret employment (3, 22). Because of the minimal and inconspicuous capital requirements, many home and personal services are provided by

moonlighters. It is estimated that one out of eight Britons earns as much as $2,200 per year from moonlighting, yet efforts to control moonlighting have been unsuccessful in Britain. The same problem has been observed in Belgium, France, and elsewhere.

Even if income is stated accurately, expenses may be overstated or even fictitious. Sales-type levies are often evaded, particularly the value-added taxes, which are "easy to evade, despite myths to the contrary" (17).

Perquisites are considered to be part of the "black economy" in Britain, where consultants may be paid in claret, and a large percentage of the automobiles are owned by firms and valued at only one third of what an independent appraisal would suggest for purposes of imputing income (6). "Friendship prices" and under-the-table exchanges flourish from Thailand to France, as well as in Britain. In Japan, "backdoor admission fees" are paid to universities, and entertainment establishments increasingly evade taxes. In the USSR, the second economy is composed of private producers who must pay bribes to facilitate production of goods and services unavailable from the state (9, 21). The diamond industry successfully evades taxes at all levels of production in many countries (2).

Control measures are largely unsuccessful, but France has launched a publicity drive against unlicensed house painters and artisans. Britain has tried to fine construction firms using unregistered workers, but fines have not successfully curbed this practice (3). It has been suggested that less government supervision and involvement are desirable, that self-policing through VAT and household deductions for repairs (against imputed income of owner-occupancy) be used, that as much activity as possible be legalized, and that business and employment costs be kept as low as possible (2, 15). Tax treaties should be designed to curb transfers between countries that might result in evasion of tax.

PUBLIC OPINION

There have been several interesting studies of public opinion about the underground economy and tax cheating in general. A Roper study (20) found that a belief that tax cheating is widespread is a stronger motivation for people to engage in bartering than is a belief that taxes are too high. A study conducted for the IRS by CSR, Inc. (4) found that only 13 to 14 percent of the respondents report having interacted with the underground economy, and no more than 17 percent agree with statements that tax cheating is acceptable. However, 27 percent admitted to being less than completely honest, and 9.1 percent stretched the truth a little in filing their 1978 tax returns.

In ranking the relative severity of various crimes, only 58 percent thought that stealing $500 from the government in taxes was "very serious," compared to 71 percent who thought it a very serious crime to steal $500 in cash from an employer, 69 percent who would not illegally obtain $500 in food stamps or welfare payments, and 62 percent who would not countenance stealing $500 from a giant corporation (4).

In Britain, only 31 percent of those questioned thought it was wrong to avoid tax on income earned in one's spare time (17). A Westat, Inc., study (5) found that noncompliance in the United States is also greater on secondary sources of income. Dollars withheld from the principal salary are considered to be the government's share, while dollars received from a second job or from a hobby in which the taxpayer invests time, material, and labor are regarded by many as nontaxable.

WAYS TO ALLEVIATE THE GROWING PROBLEM

While the underground economy is not susceptible to close scrutiny and detailed analysis, several things can be done to help alleviate the situation. It does seem clear that there is no single "quick fix." It is also unlikely that any two or three minor adjustments will make significant inroads on the problem. Real progress will require the coordinated efforts of Congress, the IRS, and other government agencies, and perhaps a major assist from the private sector. Attempts to educate the general public and reduce its willingness to participate in the underground economy will be more effective if they are initiated and conducted by nongovernmental groups.

Two general strategies have been suggested from time to time as possible solutions. Some say that more and better enforcement by the IRS is all that is needed. Others suggest that simply lowering the tax rates will substantially mitigate the problem. While both may be helpful, it is doubtful that either is a panacea.

Although the consensus both here and abroad is that high tax rates are a major contributing factor in the growth of the underground economy, it does not necessarily follow that reducing tax rates will cause the problem to disappear. Individuals who were motivated to find creative ways to avoid 70 percent tax rates may well continue those activities to avoid 50 percent tax rates. The underground economy seems to thrive in most countries around the world, regardless of whether their tax rates are higher or lower than ours.

Enforcement Activities

The IRS has estimated that a revenue agent can produce as much as $20 for every $1 of cost. More and better enforcement is, undoubtedly, needed and desirable. However, no one knows or can predict the level of enforcement that would be necessary to change the underground situation appreciably; and even if it were known, it is not certain that the IRS could attract enough good professionals to reach that level of enforcement, given the existing shortage of such individuals. Given the trend toward earlier retirement ages, the IRS should consider recently retired CPAs and other business executives as a new source of qualified personnel. However, it is important to consider what level of government surveillance and investigation the American society is willing to accept. At what point might the cure become more oppressive than the disease?

The IRS can improve its effectiveness by reallocating some of its present enforcement personnel and efforts. Many tax practitioners around the country feel that too much time and effort are being devoted to unproductive trivia when they could be applied to the underground economy. Even with improved efficiency, however, it seems apparent that the IRS will need additional personnel if it is to have much impact on the underground economy.

As one step, Congress should authorize additional resources for the IRS with the mandate that these resources be used on the underground economy. While the mood of the country today seems to favor smaller federal budgets and less government interference, it is likely that the large majority of citizens who are filing properly

would welcome increased surveillance of those who are underreporting. Although reduced federal spending may be generally desirable, an increase in the IRS's budget will normally produce a reduction in the federal deficit.

Penalties

The Economic Recovery Tax Act of 1981 increases the penalties for failure to file informational returns from $1 per return and a $1,000 maximum to $10 per return and a $25,000 maximum. This is an important step in the right direction, but we also recommend the following changes in penalties. For more than twenty years, the maximum penalty for criminal fraud has been $10,000 per count. Whatever deterrent value this provision may originally have had has seriously eroded due to the declining value of the dollar. The $10,000 amount should at least be adjusted for inflation. The penalty for civil fraud should be changed from 50 percent of the total tax due to 100 percent of the tax due on the fraudulently treated items.

Many years ago, certain penalties were waived for individuals who voluntarily corrected prior underpayments. The state of Illinois proclaimed a two-week moratorium from December 28, 1981 through January 8, 1982 during which time criminal penalties were waived for taxpayers who voluntarily paid back taxes (1). Such payments were still subject to interest and civil penalties. It has been suggested that taxpayers who availed themselves of the Illinois moratorium may have created problems for themselves at the federal level. The Treasury Department should consider cooperating with states in a

program to encourage voluntary "catching up." It might be more effective to waive both criminal and civil penalties in such cases, but it does seem reasonable that interest continue to be charged. To the extent that the government already waives penalties in instances of voluntary disclosures, this policy should be publicized.

Informational Reporting

History has shown that the level of compliance improves when the individual knows that the IRS has, or will have, information about the transaction or activity. The IRS receives information from a variety of sources, including the various Form 1099s; informational schedules on tax returns, such as the partnership and the subchapter S schedule Ks; and answers to questions on the many types of tax returns.

Presently, anyone in a trade or business is required to file a Form 1099NEC for certain types of payments in excess of $600, but only if those payments are made to individuals. Such reporting should be extended to include payments made by businesses to corporations, since many individuals and other small businesses have incorporated in recent years. If this produces an unwieldy flood of paper to the IRS or an unreasonable burden on the business community, a higher threshold might be adopted. For some time, copies of all 1099s have been supplied to the government but not necessarily to the recipient of the payment. ERTA now requires copies to be supplied to the recipient as well, as is presently required for 1099s filed for interest and dividend payments. If the taxpayer is aware that a Form 1099 has been filed, he is more likely to declare the payment as taxable income.

It is impractical and unreasonable to require taxpayers to attach copies of all 1099s to the tax return, as presently required for W-2 withholding statements and interest and dividend receipts that exceed a certain threshold. However, the $600-type payments usually are included in a gross income figure so that any matching by the IRS is virtually impossible. Requiring a list of such payments in excess of some reasonable threshold would be one possible means of facilitating such matching. At the very least, the total of all 1099s received should be reported as a separate item on the tax return.

California has adopted a requirement that anyone claiming a rent credit on the state income tax return must provide the name and address of the landlord. The federal government has a somewhat similar requirement for taxpayers claiming a credit for child or dependent care. This requirement should be extended to include other credits, such as the energy credit, for payments above a reasonable threshold.

The Federal Reserve Board requires that banks report certain large deposits or withdrawals of cash, but it is our understanding that this requirement is generally ignored. The tax authorities should either initiate their own reporting requirement or prevail upon the Federal Reserve Board to enforce the current requirement more vigorously. All businesses should be required to report cash transactions in excess of some reasonable threshold, such as $3,000 or $5,000.

States should be required to provide the federal government and the taxpayer with an informational 1099 on refunds of state taxes.

A system should be devised for reporting by the organized

bartering exchanges. They might be required to report all of the credits issued to their members, or to report all transactions above a certain threshold. Similarly, some of the typically cash businesses such as auction houses, art galleries, and dealers in collectibles and rare metals might be required to report cash transactions above a reasonable threshold.

Several factors of informational reporting must be considered. The benefits are both real and psychological; real in the sense that the matching process can reveal the underreporting of income, and psychological in the sense that the taxpayer who knows that an item has been reported to the IRS is more likely to include it on the 1040. Both benefits are reduced, however, if the IRS does not have sufficient manpower to match and follow up on the information received.

Withholding

As indicated by the 1979 IRS study (14), the level of voluntary compliance is greatest when tax has been withheld at the source. That study also confirmed that the level of compliance is quite poor for self-employment income. An important portion of such income is earned by independent contractors. In 1979 the Executive Committee of the AICPA Tax Division "approved support of the concept of withholding tax from payments to independent contractors, subject to limitations and exemptions no less extensive than those recommended at that time by the Treasury Department" (Minutes, Federal Tax Division Executive Committee, July 17, 1979). This 1979 action was related to the question of differentiating and defining employees and independent

contractors. However, such withholding could raise the level of tax reporting by independent contractors. In February 1982, the Federal Tax Division Executive Committee endorsed the concept of withholding on business payments to independent contractors, with two important caveats. It does not seem feasible to expect withholding by individual households; thus, this requirement would not apply to activities such as home repairs. Secondly, it must be recognized that a payment to an independent contractor becomes a part of gross income, whereas the eventual tax liability is computed on net income. Therefore, the withholding rate should be kept quite low—perhaps 3 to 5 percent. Even at a relatively low level, the withholding would be an important factor in assuring that the contractor will include the payment in reported income.

It has often been recommended that interest and dividend payments should be subject to withholding. If the level of compliance could be raised to that achieved on salaries and wages, the government would collect some $2 billion to $4 billion more in income taxes based on the 1979 IRS study (14). In addition to this increased revenue, such withholding might be an important factor in improving the image of equity in the tax law, since many wage earners feel that investors also should be subject to withholding.

Withholding on interest and dividends has been discussed extensively and has been considered seriously by Congress from time to time. Strong objections are raised—primarily on the grounds that it would be unfair to those who will not owe as much tax as is withheld. Furthermore, it is assumed that those individuals will be required to

wait up to eighteen months to get a refund of the over-withheld tax. Some proposals attempt to overcome this problem by providing that low-income individuals and exempt organizations could file a statement with each company indicating that less tax should be withheld. This procedure would overcome the first objection, but would impose serious administrative burdens on both the payors and the payees. The payee would need to file a certificate with every payor—perhaps ten, twenty, or more corporations. New forms would have to be filed for every new investment, even for those that might be in place for a few weeks or a few days. Payors would be required to match these forms with the investors' names and to withhold at varying rates for different payees. Thus, we reject, as unreasonable and unworkable, any graduated withholding system for interest and dividends similar to the system presently in place for wages and salaries.

We do agree that in the interests of equity and maintaining the federal revenue, some form of withholding on interest and dividends is desirable. Innovative thinking is needed to find a system that can minimize the administrative burdens on both payor and payee and also minimize any economic hardship on the payees. It would be helpful if Congress and the major groups of payors and payees would work toward devising a viable system rather than simply objecting to any suggestion of withholding. We recommend that various approaches such as the following be studied and tested.

One system would shift almost all of the administrative burden to the IRS. A flat rate specified by Congress, perhaps 5 to 10 percent, would be withheld by every payor from all dividends and interest.

Eligible individuals and exempt organizations would need to file only one exemption certificate—with the IRS. The IRS would then refund the appropriate amounts on a quarterly basis. In essence, this would entail a deferral of 5 to 10 percent of interest and dividends for three to six months by those who would not owe the full 5 to 10 percent tax. After the initial deferral period, the level of income would be approximately the same as if there were no withholding. This would add a considerable burden to the administrative duties of the IRS, but it would be less than the total burden otherwise borne by the millions of payors and payees.

While the above suggestion should correct the major problems of a comprehensive graduated withholding system, it would create new problems, such as—

- The IRS would get a single exemption certificate from each payee but would have to match that with reports from payors in several different IRS regions. A quarterly refund may not be feasible.
- If the IRS did refund any excess withholding during the year, the investor would still receive a report from each payor at the end of the year indicating that tax had been withheld. All of this withheld tax would not yet have been refunded, and the taxpayer might be confused as to whether a credit should be claimed on the 1040 for some or all of the withholding.

If the flat rate withholding is held to a relatively low level—say 5 percent—refunds may be due to only a small proportion of investors. It might be reasonable to ask those investors to wait

until the end of the year to get their refunds on the basis of the regular filing. This suggests at least two additional plans for consideration:

1. Withhold 5 percent from all dividends and all business interest payments and provide refunds at the end of the year to exempt organizations and to those payees who owe less than the 5 percent tax.
2. Allow exempt organizations to file exemption certificates with each payor who would then withhold the flat 5 percent from all other dividend and interest payments. Refunds would be at the end of the year.

In any system that provides for refunds after the end of the year, it might be feasible to require the government to pay interest from the end of the year in order to help alleviate any financial burden on the payees. A 5 percent flat-rate withholding should obviate one of the perceived administrative hardships. The taxpayers should not be required to attach withholding certificates. A listing of all interest and dividends should be sufficient.

If a viable system cannot be found to substantially reduce the administrative costs to the payors, another approach might be to allow the payors a tax credit to offset some or all of those costs.

If an acceptable comprehensive withholding system cannot be found, the IRS might identify particularly troublesome situations and impose withholding only in those areas. For example, if compliance is especially poor on taxable coupon bonds, income tax could be withheld from those interest payments. Institutions presently apply with-

holding on a selective basis (such as on nonresident aliens) and should be able to apply it to specific types of bond issues.

In February 1982, the Executive Committee of the AICPA Federal Tax Division endorsed the concept of withholding at the source of interest and dividend payments provided that either the administrative burden be shifted to the government or the cost of such withholding be borne by the government.

Tips are another source of income that is seriously underreported. The IRS estimates that only about 16 percent of tip income is reported. The IRS has made many studies and has estimated the normal percentage of tip income in various types of establishments. These estimates have been accepted and upheld by the courts in several cases. However, even with these successful efforts, it seems clear that the usual enforcement techniques are not likely to be economically viable due to the large number of individuals involved and the relatively low amount of tax per individual.

Various approaches used in the past have not been effective from an enforcement point of view. Other methods that have been proposed from time to time have been subjected to severe criticism from the businesses and the employees who would be affected. If the various interested parties could be brought together to explore some innovative ideas, perhaps a mutually agreeable solution could be found. It would seem preferable for such a meeting to be sponsored by an organization that is not directly involved in the issue.

As an independent party, the AICPA Federal Taxation Division should invite representatives of the various industries and employee

groups to come together to find an acceptable approach. These interested parties should come realizing that this is a serious problem for which a solution must be found. The group should explore any and all approaches to the problem. New and innovative ideas are needed. Two such ideas that should be explored are suggested here, but all parties should attempt to come up with as many others as possible.

> A low, flat rate tax could be collected from hotels, restaurants, airports, or other establishments where tips are common. The establishments could then be authorized to withhold or otherwise collect the appropriate amounts from the employees.
>
> The income of establishments could be grossed up to include the estimated tip income of the employees. A deduction would be allowed for the amounts reported as employee compensation. This approach also might incorporate a withholding mechanism.

The IRS 1982 study shows that the tax gap on pension income is growing much more rapidly than the total gap. This trend is likely to continue as larger numbers of taxpayers receive pensions from a larger number of plans. This is a confusing area for many taxpayers because social security is tax-free, and varying amounts of many other pensions represent tax-free return of capital, while many pensions are 100 percent taxable.

Presently, pensions are subject to informational reporting on Form 1099R. The pensioner may request withholding at the source. We recommend that all taxable pension payments be subject to a modest (say 10 percent) flat rate withholding tax with the pensioner having two options:

1. Withholding at a higher rate

2. Exemption from withholding if it can reasonably be expected that no tax will be due

Currency Reform

There is another long-range approach that we have not seen discussed anywhere else. Although it is removed from the tax arena, intuitively it would seem to be worthy of consideration as a possible deterrent to the underground economy. The vast majority of transactions in the underground economy, other than bartering, are conducted with cash. In the modern world of computers and other electronic devices, there have been suggestions from time to time that modern technology may eliminate the need for cash. Credit cards, electronic fund transfers, paying bills by telephone, and shopping via cable television have all been suggested as the "wave of the future." It might be worthwhile for the government to take steps to encourage those developments and hasten the day when we might need little or no currency in circulation.

An experiment along these lines that the government might try in the near future would be to withdraw from circulation all bills larger than the $50 bill. In a widespread but completely unscientific survey of people in the business community, we have found no evidence that any legitimate economic activity would be seriously disrupted if there were no $100 bills in circulation. Yet, the number of $100 bills in circulation has increased far more rapidly than any other denomination. If it can be presumed that most of these bills find their way into both the informal and the illegal segments of the underground

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economy, the absence of such currency could be a deterrent to those activities. If it is deemed necessary or desirable to have $100 bills in our currency system, an approach used in Switzerland might be used to produce some of the same benefits. Under the Swiss system the $100 bills, and perhaps the $50 bills, would expire periodically. Anyone holding such currency would be required to exchange it at a bank.

Miscellaneous suggestions

The following are additional suggestions that should be considered:

- o States should be required to withhold from payments to lottery winners above a reasonable threshold.
- o Tax deductions should be denied for cash payments (other than W-2 type wages) above a reasonable threshold.
- o Reporting of capital expenditures, including additions to the basis of residential or other property, should be mandatory.
- o Deduction for the cost of incentives or prizes should be denied if the value is not included in a Form 1099 (such as the prizes awarded to customers who open new accounts).
- o Questions could be added to the individual 1040, Schedule C regarding any bartering or currency transactions.

Educational Programs

Some individuals may underreport income simply because they do not understand that the income should be reported. In addition, even those individuals who know they are underreporting may not understand all the potential consequences to themselves or to society.

Educational programs might be as effective as major increases in enforcement activities and would very likely be more acceptable to society.

The government should increase its education efforts. A concerted effort should be made to counter the negative publicity given the underground economy. More publicity should be given to the number of returns filed, the amount of tax paid, and the relatively high level of voluntary compliance. The IRS should better publicize its enforcement activities and the results thereof. Instructions for the various tax returns, as well as releases to the popular media, could be used to explain that bartering and currency transactions are to be reported. Special efforts could be directed at those groups more likely to be noncompliers.

It is highly unlikely, however, that government educational programs alone will be sufficient. Statements from the government are often considered to be self-serving and are viewed by many citizens with a great deal of skepticism. Any effort to modify society's views toward the tax system and toward responsibilities to society and to government would be far more effective if it were sponsored by groups outside the government. Such an effort would indeed be a major undertaking, requiring the resources of many groups, and it would be far more effective if it were a cooperative venture involving a wide variety of different types of organizations. For maximum exposure and impact, the program should be cosponsored by professional organizations, trade associations, labor groups, and civic organizations.

Such an educational program should utilize all media and should emphasize such points as—

- The present voluntary compliance system is valuable and should be preserved.
- The large majority of taxpayers do pay their tax.
- Most so-called loopholes are really incentives approved by Congress to improve our economic or social structures.
- The typical underground transactions are indeed taxable, should be reported, and are reported by most taxpayers.
- The possible consequences of participating in the underground economy include both personal risks and institutional consequences of excessive government enforcement.
- We cannot "cheat the government"; any underpayment simply adds to the burden of fellow citizens.

The CHAIRMAN. I think, just so we don't hold either Mr. Henry or Mr. Aidinoff up, we are going to have some questions that we will submit in writing. We hope that you will be willing to work with us.

It seems to me, if the IRS statistics are not particularly helpful then we ought to be looking at other ways to close the compliance gap. I can't do a thing with numbers unless somebody suggests what we should do with them.

I think the point about the illegal sector seems valid to me. I assume you can say, "Well, if they paid their taxes, we would collect so much revenue," but I tend to agree with Senator Long: If we knew who they were, they wouldn't be paying taxes, they'd be somewhere else.

But I have a strange feeling that we may have to raise some revenue in this committee, and my view is that we ought to try to get it out of compliance as much as we can and take a look at some of the large loopholes that are big enough to cover this committee-room, and then as a last resort look at the individual tax rates.

So I know we will be working with Mr. Henry and also the tax section of the American Bar Association.

So you two may be excused. The others, I guess, will have to wait until I come back.

[Whereupon, at 12:32, the hearing was recessed.]

AFTER RECESS

The CHAIRMAN. Mr. Skadden, OK.

STATEMENT OF DONALD H. SKADDEN, ASSOCIATE DEAN, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF MICH., ANN ARBOR, MICHIGAN, ON BEHALF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, D.C.

Dean SKADDEN. Thank you, Mr. Chairman.

I appear today on behalf of the American Institute of Certified Public Accountants as author of their special study on "Underreported Taxable Income; The Problem and Possible Solutions." Copies of that document have been delivered to your committee and should be considered our primary testimony today. I will give just a couple of summarizing remarks.

In the area of compliance, our report includes two major recommendations on which our Federal Tax Division has adopted an official policy position. By a two-thirds vote of the subcommittee and a two-thirds vote of the executive committee of the Tax Division, we are permitted to speak for nearly 200,000 CPA members of the AICPA.

We have taken policy positions endorsing, in concept, and I emphasize "in concept," the withholding on interest and dividends. We definitely did not endorse the version of withholding in TEFRA, but we do believe that a withholding procedure can be developed that will serve the needs of the IRS and yet be viable in its application.

We have also adopted a policy position endorsing, in concept, withholding on business payments to independent contractors. As

all of us know, the independent contractor area is one of the lower percentage reporting areas.

We also in our study suggest a number of other compliance measures on which we have not taken a policy position but which we think are worthy of serious consideration.

We think the enforcement activities of the IRS should be enhanced and partially redirected; we think information reporting should be required for business payments to corporations or barter exchanges, auction houses, dealers in collectibles, and for State tax refunds; we think the tax returns could be modified to provide better information and to facilitate the matching with informational forms. As of right now, the 1099's that are filed on business payments cannot in any way be matched with tax returns because they are buried in lump-sum figures on the tax returns.

Steps could be taken to discourage the use of currency, and if we could discourage the use of currency we might go a long way toward alleviating the underground economy. Retailers could be required to report currency transactions in excess of a reasonable threshold—perhaps $5,000; tax deductions might be denied for currency payments which are not subject to withholding or informational reporting; $100 bills might be withdrawn from circulation or subject to periodic expiration.

Since 1960, $100 bills in circulation have increased 9 to 1, whereas all bills smaller than $100 bills have increased 2.5 to 1. In our study we found no one who would indicate that the legitimate economy would be seriously hurt if $100 bills disappeared.

Major educational efforts should be undertaken by the Treasury Department and by organizations outside the Government in order to increase the general understanding of the tax law and the consequences of noncompliance, and to help overcome negative publicity regarding the underlying fairness of our present system.

In addition to the above suggestions in the area of compliance, our report also addresses the causes of underreporting both here and in other countries.

Some of the causes are rooted in a widely held and growing belief that the tax law is unfair, the Government is too big, taxes are too high, and there is excessive Government involvement in people's lives and their businesses. If Congress fails to address these underlying problems, increased enforcement activities may well be fruitless or even counterproductive.

We are very much interested in the preservation of our voluntary compliance system. It has been the best tax system in the world for 60 years or more, but it is in grave jeopardy today as increasing numbers of people fail to report fully.

Improved enforcement measures are important, but they can only go so far. A point can be reached where the cure can become more oppressive than the disease. It is imperative that Congress address the underlying causes of noncompliance as well as the details of compliance enforcement.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement follows:]

TESTIMONY OF DONALD H. SKADDEN, MEMBER, TAX POLICY SUBCOMMITTEE, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

We appreciate this opportunity to appear before you to discuss matters of tax compliance. I appear today as Chairman of the Task Force and author of the AICPA study entitled "Underreported Taxable Income: The Problem and Possible Solutions," copies of which have been delivered to your Committee and should be considered as our primary testimony today.

In the area of compliance, our report includes two major recommendations on which the AICPA Federal Tax Division has adopted an official policy position, plus several suggestions on which we have not taken an official position, but which we believe are worthy of serious consideration.

Speaking for nearly 200,000 CPAs, the AICPA Federal Tax Division has endorsed in concept:

1. Withholding on interest and dividends (We have not endorsed the TEFRA version of withholding, but we believe a withholding procedure can be developed that will serve the needs of the IRS yet be viable in its application.)

2. Withholding on business payments to independent contractors.

Additional compliance measures which we believe should be considered are:

1. The enforcement activities of the IRS should be enhanced and redirected.

2. Informational reporting should be required for business payments to corporations, and for barter exchanges, auction houses, dealers in collectibles, and state tax refunds.

3. Tax returns could be modified to provide better information and to facilitate matching with informational forms.

4. Steps could be taken to discourage the use of currency:

a. Retailers could be required to report currency transactions in excess of a reasonable threshold—perhaps $5,000.

b. Tax deductions might be denied for currency payments not subject to withholding or informational reporting.

c. $100 bills might be withdrawn from circulation or subject to periodic expiration.

5. Major educational efforts should be undertaken by the Treasury Department and by organizations outside the government, in order to increase the general understanding of the tax law and the consequences of non-compliance, and to help overcome negative publicity regarding the underlying fairness of our present system.

In addition to the above suggestions in the area of compliance, our report also addresses the causes of underreporting both here and in other countries. Some of the causes are rooted in the widely-held and growing beliefs that the tax law is unfair, government is too big, taxes are too high and there is excessive government involvement in people's lives and their businesses. If Congress fails to address these underlying problems, increased enforcement activities may well be fruitless or even counterproductive.

STATEMENT OF WILLARD TAYLOR, ESQ., ACCOMPANIED BY MICHELLE SCOTT, ON BEHALF OF THE NEW YORK STATE BAR ASSOCIATION, WASHINGTON, D.C.

Mr. TAYLOR. I am the chairman of the section of taxation of the New York State Bar Assocation and appear on behalf of the section with Michelle Scott, who is the cochair of our committee on compliance and unreported income.

We filed a statement for the record, and all I will do is summarize the main points.

First, we regret the success of the efforts to repeal the withholding tax on interest and dividends. We supported withholding prior to the enactment of TEFRA; we continued to support it during the subsequent debate on its repeal.

We feel that withholding is a fair, efficient, economical, and nonintrusive means of tax collection. We hope that ultimately the subject will be revisited, and that there will be withholding on interest and dividends and perhaps other passive income.

The strength of the antiwithholding movement may suggest, however, that at least for the present time the effort to have the private sector play a role in tax collection is going to be difficult. And given that situation, I think we feel very strongly that the existing collection and enforcement authority of the Internal Revenue Service be fully exercised. And in that connection we strongly urge that Congress increase appropriations for the Internal Revenue Service and for the Treasury Department.

There are really three areas in which this needs to be done: First of all, to implement the broader reporting requirements, it is imperative that the Internal Revenue Service have the computer personnel, hardware, and software needed for matching information reports with tax returns.

Second, there should be increased funding for Internal Revenue Service enforcement.

And finally, we think there ought to be increased funding for Treasury and Internal Revenue Service tax policy staffs to get regulations out that clarify the application of the law.

With respect to TEFRA, we generally supported the compliance provisions of TEFRA. We think that they have to be monitored to make sure they work; but at this time, apart from reiterating our support for withholding, we do not suggest that Congress deal further with the matters covered by the TEFRA compliance provisions.

We do, however, believe that it is appropriate for Congress to deal with other compliance-related problems that were not addressed by TEFRA. Of these, one very important area is the so-called cash economy. It goes without saying that cash payments facilitate tax evasion by the payee. We think they also facilitate tax evasion by payors by allowing them, with little danger of detection, to dispose of cash income they have received but not reported.

We believe, and have previously recommended, that the Treasury Department should be given the authority by regulation to require persons making or receiving large cash payments—say, in excess of $2,000—to report such payments and the name and address of the other party to the transaction to the Internal Revenue Service, and consistent with that, that substantial penalties be attached to the failure to report large cash transactions. We would anticipate that those regulations would not, however, become effective until the Internal Revenue Service was in a position to utilize the information that it obtained.

Second, we think that Congress ought to consider legislation requiring people who organize flea markets, craft fairs, and like events, to report at least the names and addresses and identifying numbers of the participating vendors to the Internal Revenue Service. We think that will bring those people into the tax system.

Finally, we think that noncompliance in the cash economy could be reduced by greater cooperation between the Internal Revenue Service and State and local authorities. State and local authorities may have information, for example, with respect to cash businesses from sales tax returns and sales tax examinations, or from vendors' licenses which may be of great use to the Internal Revenue Service in starting the paper trail to identify tax evasion.

We think also that the knowledge of such cooperation will also operate as an incentive to report income.

Those are the main points, and I thank you very much for the opportunity to testify today.

[The prepared statement of Willard Taylor, Esq. follows:]

STATEMENT OF WILLARD B. TAYLOR, CHAIRMAN, TAX SECTION, NEW YORK STATE BAR ASSOCIATION

Mr. Chairman, members of the committee, thank you for inviting me to testify this morning. My name is Willard Taylor and I am the chairman of the Section of Taxation of the New York State Bar Association and appear today on behalf of the members of the Tax Section. I am accompanied by Michelle Scott who is cochair of the Section's Committee on Unreported Income and Compliance.

The Tax Section has over 2,500 members, all of whom are lawyers with a professional interest in taxation. They include practicing lawyers, teachers, corporate counsel, and officials and employees of the Treasury Department, Internal Revenue Service, and the New York Department of Taxation and Finance.

I appreciate this opportunity to testify before the Finance Committee with respect to the Tax Section's continuing concern about noncompliance with the federal tax laws. We have generally supported legislation developed by this Committee to improve compliance. In particular, we have supported compliance-related provisons of the Economic Recovery Tax Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982. We have enjoyed a cooperative and, we believe, constructive relationship with the committee staff in evaluating measures to encourage tax compliance and to reduce unreported income and unpaid taxes.

WITHHOLDING

Because we are deeply troubled about noncompliance with the internal revenue laws, the Tax Section regrets the success of efforts to repeal withholding on interest and dividends. We supported withholding prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 and we urged its retention during the subsequent debate on its repeal. The success of the repeal effort raises questions about the willingness of some taxpayers to bear their fair share of the Nation's support, and it undercuts avowals of concern about noncompliance. What should wage-earners, whose earnings are subject to withholding and who pay over 99% of their tax liability, think of a system which effectively permits substantial amounts of investment income to escape tax?

Improving tax compliance is also part of an effort to close a $100 billion tax compliance gap, as emphasized by the announcement of this hearing. Repeal of withholding on interest and dividends eliminates a significant step toward closing the gap and threatens continued revenue losses.

In addition to advocation the enactment of withholding on interest and dividends, the Tax Section has recommended that the Congress consider applying withholding to additional categories of passive income, such as rents and royalties. In our view, withholding is a fair, efficient and economical, and nonintrusive means of tax collection. We hope that eventually the benefits of withholding for both taxpayers and administrators will be understood and that a system of withholding on interest and dividends and, perhaps, other passive income, will become law.

IRS APPROPRIATIONS

At least for the immediate future, the strength and success of the anti-withholding movement may suggest that the private sector reluctance to play a role in tax collection will make it difficult to assign it any new direct responsibilities. Given this unfortunate situation, we believe it is essential that the Internal Revenue Service's existing collection and enforcement authority be fully exercised. In this connection, the Tax Section urges again that the Congress increase appropriations for the Internal Revenue Service and for the tax policy staffs of the Treasury Department. In view of the new, broader information reporting requirements about to become effective, it is imperative that the Internal Revenue Service have the computer personnel, hardware, and software needed for matching information reports with tax returns. Additional information reporting will be of no benefit if the IRS lacks the staff and equipment to process and use such information.

Funding for IRS enforcement activities should also be increased. The current level of resources allocated to the IRS is insufficient for effective implementation of the

present compliance rules. The General Accounting Offices has estimated that the number of tax returns filed with the IRS were expected to increase by 17 percent during the period from 1976 to 1983. During the same period IRS examination resources were expected to increase by only 2 percent. This means that the percentage of returns audited will decrease from a level of 2.6 percent in 1976 to approximately 1.67 percent in 1983.

As a result of this low and decreasing level of audit coverage, more and more taxpayers will be inclined to take their chances in "audit lottery." No enforcement measure can deter noncompliance unless the taxpayer is convinced that there is a genuine chance that the measure will be enforced against him. Accordingly, the Tax Section believes that additional funds must be committed to the IRS in order to ensure that it has the necessary enforcement resources both in the short run and over the long term.

The Internal Revenue Service occupies a unique role in the budget process. It has been estimated that every dollar spent by the IRS in enforcement raises $3 to $21.60 in revenue, depending on the particular program involved. While at some point the marginal return on each dollar spent for IRS enforcement may drop below $1, that point is far off. Increased IRS outlays are the only budget appropriations which directly and measurably increase Government revenues.

In connection with consideration of revenue-producing appropriations, the Tax Section also believes it would be helpful to increase the resources of the tax policy offices of the Treasury Department and IRS. The promulgation of rules and regulations is hampered by the small size of the Government's tax staffs. The last several Congresses made many substantial changes to the Internal Revenue Code. Regulations have not even been proposed under most of these new provisions. The issuance of regulations would clarify the application of these new tax laws and would reduce both witting and unwitting tax avoidance attributable to the indefinite state of the law. In addition, increasing the tax policy staffs would facilitate the publication of more and earlier rulings to deter abusive tax shelter schemes. Greater funding for tax personnel should produce a benefit in both compliance and revenues.

TEFRA EVALUATION

As I have indicated, the Tax Section generally endorsed the TEFRA provisions creating new withholding and reporting rules and new and tougher penalties for noncompliance. Over the last few years, the Tax Section also supported tax proposals to adjust the interest charged (and paid) by the IRS in order to bring IRS rates closer to market rates; to improve partnership audit techniques; and to prevent tax-avoidance through the use of abusive shelters. We have also supported legislation codifying responsibilities of tax professionals with respect to return preparation, and have worked with the Treasury Department to develop meaningful standards for tax shelter opinions. Because these changes have so recently been enacted into law, it is still too early to judge whether they are actually producing their intended results and improving tax compliance. Their implementation should be monitored and evaluated by the Finance Committee, however, to ensure that they operate properly and to make any adjustments which become necessary.

We do not at this time advocate additional measures to deal with the matters addressed by TEFRA—apart from reiterating our endorsement of withholding. We believe, however, that it would be appropriate for the Congress to deal with other compliance problems which were not addressed by the 1982 legislation.

CASH ECONOMY

One important area of noncompliance which will not be affected by the TEFRA compliance provision is the cash economy. A significant amount of income from legal sources goes completely unreported because the recipients of such income are paid in cash. These recipients include repairmen, other providers of services, salesmen of various types, flea market and street vendors, and others. In fact, because cash payments leave no "paper trail" and thus can easily be kept outside the tax system, sellers and providers of services will often quote two different prices to a prospective customer: one for a cash payment and another, much higher, price for payment by check or credit. While the payor in such cases knows or suspects that a cash payment will facilitates tax evasion by the payee, he has no further incentive to decline the lower, cash price nor any obligation to report the transaction to the IRS. The cash economy also facilitate tax evasion by payors by allowing them, with little danger of detection, to dispose of cash income they have received but not reported.

We believe this situation must be changed, and recommend (consistent with our prior views) that the Secretary of the Treasury be authorized to issue regulations under which all persons making or receiving large cash payments (in excess of, say $2,000) would be required to report such payment and the name and address of the other party to the transaction to the IRS. Failure to report such a payment could result in the imposition of a substantial penalty based on the amount involved.

In this way, persons making or receiving large cash payments for propery or services could not claim innocence of complicity in tax evasion by the other party to the transaction. Moreover, with the reporting requirement in place, parties to cash transactions could no longer be assured that cash payments would escape detection by the IRS. We would anticipate that the regulations would not become effective until the IRS is in a position to utilize the information obtained. Once the system is in place, the eventual result could be a significant decline in the size of the cash economy and in the taxpayer noncompliance associated therewith.

We further recommend legislation to require persons organizing flea markets, crafts fairs, etc. to report at least the names, addresses and identifying numbers of the participating vendors to the IRS. In this way, the IRS would have a starting point to bringing the income of these taxpayers into the tax system.

Finally, the committee believes that noncompliance in the cash economy could be reduced by greater cooperation between the IRS and state and local authorities. The latter authorities may have information with respect to cash businesses (for example from sales tax returns and examinations or from vendors' licenses) and may be able to provide the IRS with the names and addresses, social security numbers and gross receipts of service providers, vendors, etc. The IRS might be able to combine this information with spot audit techniques to tax some of the unreported income of these taxpayers, and the knowledge of such cooperation might itself deter tax avoidance.

COMPLEXITY

Compliance with the Internal Revenue Code depends not only on taxpayers' willingness to comply with the tax law but also on their ability to understand it. Complexity, particularly in the individual income tax provisions, makes compliance difficult and often expensive. For this reason, the Tax Section has long favored simplication of the tax law and urges that greater attention be paid to simplification proposals, such as the "Fair Tax Act" introduced by Senator Bradley.

The high rate of change in the tax law over the last decade also has served to confuse taxpayers and discourage their compliance efforts. We recognize that many of these changes were necessary and, indeed, we supported many of the proposals. In general, however, further changes should be undertaken more gradually and systematically, so that taxpayers can acquire understanding of the law, familiarity with IRS instructions and forms, and certainty about their responsibilities.

The Tax Section remains, as always, ready to assist this committee in its efforts to improve the Federal tax law and to increase compliance with it.

Thank you for allowing me this opportunity to share our ideas with you. I will be pleased to answer any questions which the committee may have.

The CHAIRMAN. Well, I guess it is fair to assume that both witnesses would agree that reporting of cash purchases and other cash transactions might be able to permit the IRS to identify illegal source incomes.

Mr. TAYLOR. That is certainly our view. Yes, sir.

The CHAIRMAN. And as I think you have just indicated, that can be done without any excessive burden on small business, however you define small business.

I think that is one of the objections we have in the compliance area, that it is hard to make a distinction between small business, whatever it might be, and others, and everyone, of course, rebels against any more reporting. On the other hand, I just can't subscribe to the view that we shouldn't try to collect taxes that are due.

We appreciate the New York Bar's assistance on withholding. I would guess you are probably right. It would seem to me that, at least for some time, unless there is a new way to do it as suggested

by Mr. Skadden, there will be little interest in mandatory withholding. Have you developed that new approach to withholding?

Mr. SKADDEN. We suggest two or three in our study that we think ought to be explored. We have not endorsed any one of them, but we recognize the difficulty of withholding on interest and dividends when the exemptions are allowed and exemption certificates have to be filed with every payor. Exemption certificates for salaries are one thing, but an exemption certificate when you are changing a stock investment several times a year is quite a different matter.

We think that can be avoided.

The CHAIRMAN. I think that is a legitimate concern that the financial institutions had, and, frankly, the exemptions are probably proliferated because we needed additional votes to pass it in the first place. If you look at the political realities on the one hand and the administrative problems you create on the other, I think you are correct. I'm not certain that would have eliminated the opposition, but there were some who had just concerns about the problems the exemptions caused, and I think they were probably correct.

Mr. SKADDEN. We suggest two ideas. One would shift that administrative burden to the Government and allow the taxpayer to file one exemption certificate only with the IRS and not with every payor. The IRS would refund those interest payments to those who are not taxable on them.

And second, would be a very simple provision to drastically lower the withholding rate to 3 or 5 percent, and not give anybody exemptions. Let people have a 3 to 9 month delay on receiving 3 to 5 percent of their dividends and interest.

The CHAIRMAN. Well, we are informed, again, that estimates tend to be wrong; but with our so-called backup withholding provisions and other penalties, if we have the resources, we will still be recovering about 68 percent of the tax that would otherwise be lost. Now, figures are illusive, but it is going to depend on additional resources, which both of you I assume support.

Mr. SKADDEN. Yes.

The CHAIRMAN. Well, thank you very much. We appreciate your support and your testimony.

Thank you.

We have a panel now of Mr. Cohen and Mr. Goldberg. Mr. Cohen is a familiar face before the committee—we are happy to have you back—and an Assistant Secretary of the Treasury from 1969 to 1972. Mr. Goldberg was very helpful, principally responsible for last year's compliance bill. You are now in private practice—I hope that it was a promotion.

Mr. GOLDBERG. I'm not sure.

The CHAIRMAN. It had to be if you left Government.

I think, Mr. Cohen, we will take you first. And again, if you will make your primary points, we would appreciate it. Your statement will be made a part of the record.

STATEMENT OF EDWIN S. COHEN, ESQ., COVINGTON & BURLING, WASHINGTON, D.C.

Mr. COHEN. Thank you, Mr. Chairman. I have a very brief statement, and I will summarize it, I hope even more briefly.

I appear before you this morning solely on my own behalf and not in representation of any client or organization. I come in order to offer to the committee a suggestion that the Federal Government create a commission to consider and recommend at an early date, measures to deal with the problems that the Nation faces on these compliance issues.

I would say that I have come to this conclusion with great reluctance because, although there have been suggestions many times for Commissions to study tax policy issues, I have been skeptical of the chances of success because of the great divergence of opinion.

But I have concluded in my own mind, at least, that a Commission to consider proper measures, efficient measures for enforcement of the tax laws, and compliance with them could accomplish a tremendous amount in insuring public confidence that the decisions made in this area have been based on all of the available facts and the assessment of all of the procedural alternatives that are available. And I think it would enable the committee to fashion its decisions with a great deal more assurance. I think public confidence is important to whatever we do in this area.

In my prepared statement I have explained why I come to this conclusion. I think in particular, you need to bring together many different talents, not just those of lawyers and accountants, revenue estimators, and government administrators but also, in the private sector, the administrators of the system for payors. You need management consultants and systems experts, those who understand the new technology that is available and on the horizon.

The only way I see to do that effectively, and also to instill public confidence in the decisions, is to bring them together on a Commission and have that Commission hopefully make at least a preliminary report to this committee and to the Congress, say by April 1 of next year, and perhaps a final report by January 1, 1985.

I won't elaborate on this at this point, in view of the shortness of time, but I make this suggestion, as I say, with reluctance. But having dealt with this problem in and out of the Government for more than 20 years, I think this is a suggestion that is worthy of very serious consideration.

[The prepared statement follows:]

STATEMENT OF EDWIN S. COHEN

My name is Edwin S. Cohen. I am a partner in the law firm of Covington & Burling in Washington, D.C. and a professor of law at the University of Virginia Law School.

I appear before the Committee today solely on my own behalf and not in representation of any client or organization. I do so in order to offer to the Committee a suggestion that the federal government create a commission to consider and recommend at an early date measures to deal with the problems that the nation faces regarding compliance with the federal tax laws.

I have come to this conclusion with considerable reluctance. Although calls have frequently been made for commissions to study federal tax policy, I have been skeptical as to the likelihood of success because of the wide divergence of economic, social and political views on the subject.

But I suggest that the time has arrived when a governmental commission to examine and make recommendations regarding procedures for enforcement of the tax laws could make a vital contribution. I would distinguish between a commission to recommend policies as to the amount and types of taxes to be levied and one to recommend appropriate means of insuring their collection. Even if the commission's procedural recommendations produced dissents or were not found acceptable to the Congress and the President, it would nevertheless perform a distinct public service in laying out the facts and analyzing the issues and alternative remedies that are available. An objective study and comprehensive report on major compliance issues would enable the Congress to make informed decisions and provide the public confidence and support for those decisions that are vital to the collection of the nation's revenues.

I think it may be said that the legislative and grassroots maneuvering in the past year with respect to a number of compliance issues, particularly with respect to withholding, have not been such as to inspire public confidence. Charges and countercharges have been hurled, often with little factual basis and even less logical analysis, resulting in public dismay and confusion. I do not mean to suggest that fault or blame should be assigned to anyone, but only that the present procedures for developing solutions to these major problems are falling short of the goal. I urge on you that the time has come for a fresh start on these compliance issues, and that the best available procedure is to establish a nonpartisan governmental commission charged to analyze the facts and issues and to report back, at least preliminarily, by April 1 of next year.

Designing of an efficient compliance system requires the welding of many talents. The vast recent technological advances in computers and other devices present opportunities for solutions that have only recently become available or are just on the horizon. To develop the solutions we need not only legislators, lawyers, economists, revenue estimators, and government administrators, but systems analysts, private sector administrators and other experts familiar with the new and developing technology.

In my experience, both in and out of government, I have found it extremely difficult to bridge the gap between the youthful designers and operators of sophisticated modern equipment and systems on the one hand, and on the other hand the older persons who are in the position to make important policy decisions. The younger persons have grown up in a different technological environment and they speak a lingo that is difficult for their elders to comprehend. The designers and operators are not accustomed to writing memoranda or testifying in terms that policymakers understand. The objective of a commission would be, among other things, to bring these groups together and bridge the gap between them.

No one could have a higher regard than I have for the ability, intelligence and dedication of the staffs of this committee, the Joint Committee on Taxation and the House Committee on Ways and Means. They have contributed many useful ideas toward solution of the complex compliance problems we face. But their work should be supplemented by that of experts in systems and technology who can lend their experience and special training to achieving the solutions. A commission would permit this merger of expertise.

Needless to say, the Internal Revenue Service also has many able and dedicated experts in these fields. Unfortunately, it is not likely that the Service would be regarded by the tax paying public and by payors as sufficiently neutral in weighing the alternative courses. It should, of course, be closely involved in the study and play a vital role.

I realize that the committee amendment to H.R. 2973, adopted by the Senate last week, provides for a report on this subject to be rendered by January 1, 1988 by the Comptroller General. But that report is to deal with the collection of taxes on interest, dividends and patronage dividends, and it is not expected to be filed for another four and a half years. I suggest that there is need for a study and recommendations with respect to other types of income as well, as to which the revenue gap is understood to be greater. Moreover, some recommendations, at least, could be forthcoming well within a year's time, and the presence on the suggested commission of private citizens would be of great assistance in generating public confidence in the system.

The American Bar Association is also initiating a long-range project to study and make recommendations for improvements in tax compliance. I believe such a study is eminently desirable and should be encouraged. But I understand that the proposed American Bar Association study will be broader in scope and take longer to complete than the more limited inquiry that would be the task of the commission. The commission, I suggest, should be concerned primarily with analyzing the availa-

ble systems technology—what might be called the "nuts and bolts" of compliance procedures—and the cost-benefit aspects of the possible alternative solutions.

The ingenuity of our best minds and the application of our best technology are needed to close the compliance gap. The stakes are high. Even a partial closing could produce on the order of $25 billion. This should be a national effort, in which there should be joined both large and small business, both academicians and practitioners, both those who design and run the systems and those who make executive and policy decisions, both the bright young stars of the electronic generation and the wise and experienced gray heads. I submit to you that such an environment is not likely to exist on Capitol Hill, and that the public senses this is the case.

Thus I come to the conclusion, somewhat reluctantly but inevitably, that a governmental commission on this subject is much needed. The issues, the analyses and the proposed solutions should be laid out for the American people and their elected representatives in Congress to see and to understand. I have faith that they will respond when they are convinced that the stakes are high and that an impartial and thorough evaluation of the possible solutions has been completed.

The CHAIRMAN. We appreciate the suggestion. It appears to me that I would probably have the same reservation about commissions, but we have had one success with the commission in the social security area recently.

Mr. COHEN. Yes.

The CHAIRMAN. So maybe that established new precedent for commissions and their work, and it is something we will look at very carefully.

Mr. Goldberg?

STATEMENT OF FRED T. GOLDBERG, JR., ESQ., WASHINGTON, D.C.

Mr. GOLDBERG. Thank you, Mr. Chairman.

I think that without question all early indications are that the compliance provisions of TEFRA—those that survive—will have a substantial positive impact on tax administration and voluntary compliance. I believe the measures will be successful beyond the most optimistic projections of those supporting this passage. Unfortunately, as you well know, much remains to be done.

What has surprised me today during the course of the hearing is that there seems to be an extraordinary consensus on the short-term and longer-term solutions to much of the compliance problem. I think you have heard from all of us that withholding is ultimately the right answer, and it is the only right answer. We may have lost the fight for now, but I think every witness today has said that it is ultimately where the system has to go—not only in the interest and dividends area but perhaps in the independent contractor area, in the rents and royalties area, and the like.

I think most of us who have looked closely at the question are confident that a workable, administrable system can be devised.

In response to your comment to one of the prior witnesses, for example, I believe, I am confident, that the Internal Revenue Service could assume full responsibility for administering the exemption system directly, taking that entire responsibility off the backs of the financial institutions.

The CHAIRMAN. That would be very helpful if they could work that out.

Mr. GOLDBERG. I would encourage you to inquire as to whether perhaps they haven't already determined that it can be worked out. And I think it would be most unfortunate to give up the fight forever.

The CHAIRMAN. Can they do it on tip reporting, too?

Mr. GOLDBERG. I think that the burdens there are so minimal to begin with that not much is required.

On tip reporting, by the way, I believe that these rules will come to be perceived as perhaps the most innovative and most effective of all of the compliance provisions in TEFRA, and I would urge the committee to look to other areas where the same approach can be applied. I think it is perhaps the best mechanism that has been found to improve voluntary reporting of income in difficult to reach areas.

IRS resources is a second point. Again, I think there is unanimous agreement that in the short run increased funding is the best way to get at the compliance problem. The IRS could realistically absorb budget increases that would raise between $6 and $8 billion between now and 1987. That's 10 percent of the amount called for by the proposed budget resolution.

The CHAIRMAN. How would you do that?

Mr. GOLDBERG. By increasing funding for the Internal Revenue Service.

The CHAIRMAN. I think you are correct.

Mr. GOLDBERG. And you just need to do that.

Cash-transaction reporting is a third area. Again, I think there is a general consensus that a workable system and a necessary system can be devised. I think you ought to start with the casinos.

The CHAIRMAN. Casinos?

Mr. GOLDBERG. Casinos are currently exempt from cash-transaction reporting. The amount of funds being laundered through casinos today is staggering. If you go to the window with your cash, they wire it offshore, and there is no report filed.

The role of practitioners is a fourth point. TEFRA and the Tax Reform Act of 1976 have delineated for the first time our professional responsibilities. I believe we do have a responsibility in improving and maintaining the health of the system. I believe that enough has been done for now, but I think that this is an area that most appropriately should be watched by the committee. If the judgment is that taxpayers are continuing to play the so-called audit lottery with us as witting or unwitting agents, I think more needs to be done.

Finally, IRS research. I believe, again, that there is across-the-board agreement that we simply do not have the information to answer types of questions that we are asking in a way that makes a difference from your standpoint. TEFRA started down the road by mandating a couple of research projects. I am confident there are any number more. If you ask the right question the right way, you can get the answers that will lead you toward partial solutions to the compliance problem.

Again, I thank you for the opportunity to appear today.

The CHAIRMAN. Well, thank you, and, again, thank you for your previous assistance. Again, it seems to me if there is any responsibility this committee has on the revenue side it is to try to collect the taxes that are due, and it's not going to be easy.

We all go out and make great speeches about all of this noncompliance, and then to muster 11 votes out of 20 sometimes is difficult. But it is not a partisan matter; it just seems to me the taxpay-

ers have the right to expect that their neighbors are paying their taxes. And whether you are making $15,000 or $50,000 or $100,000, everybody ought to make a contribution.

I am a little leery of commissions, but maybe this one might have some use in it.

Mr. COHEN. Mr. Chairman, I have come to that conclusion because I think you need someone to sift through all of these ideas before they come to you.

I think, while the Service has many capable people, and this committee, Ways and Means, joint committee, have capable, industrious, and hard-working people—I have no doubt of their ability—I think the only way to produce these ideas and to weigh them in a nonpartisan, nonpolitical fashion before they are presented to this committee, is to have a commission sort them out. It is more important that they sort them out than precisely what their recommendations are. You could choose between the recommendations, but they could lay the facts out for you in a way that the public would have confidence in, and I think that is quite important.

Unfortunately, I think the IRS is not in a position to do that for the public, because of the general feeling that they are the "revenooers," and I think you need some neutral observers on the commission to balance the report.

The CHAIRMAN. What we may have to do—we have a little trouble getting money out of the Appropriations Committee—maybe we should just allocate a portion of collections to enforcement.

Mr. GOLDBERG. Your yield is 10-to-1 on every dollar you spend. And it makes no sense not to do it.

The CHAIRMAN. I know. I don't think there is any difference of opinion on that on the House side, and we work closely with the Ways and Means Committee. And I think that must be our first effort before we dream up any more complicated schemes.

Thank you very much.

Mr. COHEN. Thank you.

The CHAIRMAN. Our final witness is Ron Sarasin, director of Government relations, National Restaurant Association.

STATEMENT OF FRED T. GOLDBERG, JR.

Mr. Chairman and members of the Senate Finance Committee: My name is Fred Goldberg. I am a partner in the Washington office of the law firm of Latham, Watkins & Hills. During 1981 and 1982, I had the privilege of serving as Assistant to the Commissioner of Internal Revenue. In that capacity, I devoted much of my time and attention to issues of tax compliance and to development of the compliance provisions of the Tax Equity and Fiscal Responsibility Act of 1982 [TEFRA]. As such, I greatly appreciate the opportunity to appear before you today. I am here in my individual capacity and am not representing any client interest.

Without question, all early indications are that the compliance provisions of TEFRA—at least the ones that are not repealed—will have a substantial positive impact on tax administration and voluntary compliance with our tax laws. Indeed, I believe these measures will be successful beyond the most optimistic projections of those who supported their enactment. Unfortunately, however, much remains to be done. To put the matter in perspective, the proposed compromise budget resolution calls for raising additional tax revenues of close to $75 billion over the next three years. During that same period, revenues lost from noncompliance will exceed $300 billion. The eminent repeal of withholding alone will cost the Treasury more than $20 billion between now and 1987.

Based on my experience with the IRS and as a private practitioner, I would like to comment briefly on five matters that I believe are central to the issue of tax compliance. Each merits particular attention because it is applicable not only under the

current system but also in the context of most serious proposals for basic tax reform.

1. *Withholding.*—Any consideration of ways to improve compliance must start with withholding. Without belaboring the point, suffice to say that withholding was, is and will remain the only truly effective way to assure widespread reporting of taxable income. While much has, can and should be done to improve information reporting, it will never come close to achieving compliance levels that can be achieved through withholding.[1] While I recognize that the subject is taboo for now, and perhaps forever, we should not fool ourselves. We should acknowledge what has been acknowledged by the AICPA, the Tax Section of the American Bar Association, every Commissioner of Internal Revenue for the past 25 years and, indeed, virtually everyone who has given serious and fair-minded thought to the question: Withholding is the fairest, least intrusive, most effective and least burdensome way to assure compliance with the tax laws. It can and should be extended to cover not only interest and dividends income, but other periodic payments as well. We may be 5, 10, or 15 years away, but until we get there, the system will be losing tens of billions of dollars annually that it can only recoup through higher taxes on the rest of us.

2. *IRS resources.*—It is clear that the IRS is woefully short of resources. Once again, this view is not seriously disputed by those who have given the matter serious thought and attention. To put the matter in perspective, the Service could realistically absorb additional resources over the next three years that would allow it to generate net additional revenues to the Government of between $6 and $8 billion—almost 10 percent of the amount called for by the proposed Congressional budget resolution. The administration and Congress should recognize that the IRS budget is unique. It is the only appropriation that raises money as opposed to spending it.

In light of recent House Appropriations Committee action, I urge you to take note that funds for continuing, accelerating and expanding the IRS automation efforts are imperative. It does not overstate the case to suggest that the entire system of tax administration is at stake on this point.

I certainly recognize that withholding may be dead, if not buried, for now, and that substantial IRS budget increases may not be feasible at present. They remain, however, the two most effective means to close the compliance gap.

3. *Cash transaction reporting.*—For obvious reasons, cash transactions are at the core of the compliance problem. This has prompted the AICPA, the Tax Section of the American Bar Association, the New York State Bar Association and many others to suggest that large cash transactions be subject to information reporting. While there are many unresolved issues of coverage, privacy, administration and the like, some form of reporting is clearly warranted and workable. I strongly urge the committee to develop such proposals and seek their enactment at an early date. The starting point, whether by legislation or regulations, should be to require currency transaction reports from casinos. Money laundering through these enterprises is occurring at an alarming and increasing rate, particularly as the government steps up its effort to enforce currency transaction reporting requirements applicable to other financial institutions.

Illegal sector income was largely untouched by TEFRA last year. Expanded cash transaction reporting may be the only way to get at some part of this problem.

4. *Role of practitioners.*—Starting with the return preparer construct in 1976, and culminating with a variety of TEFRA penalties, Congress has begun to regulate the conduct of tax practitioners. Our role in the system of voluntary compliance is all persuasive and hardly needs recounting. As you know, 75 percent of all individual income tax returns and virtually all partnership and corporate returns are now preparer-signed returns. Tax opinions are the essential key to marketing tax shelters. In-house tax managers and their accountant and attorney advisors play critical roles in structuring business transactions with a view to minimizing tax liability. In recent years, the investment bankers and their tax advisors have become extremely active in their efforts to design tax driven transactions.

I believe the Congress has been telling us, as tax practitioners, that we have a role to play in maintaining and restoring the health of the tax system. I think this directive is most appropriate. Despite criticism by some professional groups, I also think that the parameters of our responsibility are clearly and properly defined, at

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[1] TEFRA made enormous positive strides in the area of expanded information reporting. These measures should be retained and implemented, but nothing additional should be enacted for the time being. Down the road, however, information reporting on the deductions side should be given serious consideration. More importantly, the approach to tip income reporting should be applied in other contexts. In my view, the tip reporting rules will come to be viewed as among the most innovative and effective of all of the TEFRA provisions.

least for the time being. We are now subject to substantial civil penalties for aiding and abetting tax fraud and for our participation in the marketing of abusive tax shelters. As a practical matter, we are also indirectly reponsible for enforcing the reporting standards established by TEFRA's substantial understatement penalty. Those we represent will be subject to that sanction if they lack substantial authority for, or fail to disclose, positions they take in their tax returns. Presumably, those we represent will expect us to advise them as to their responsibilities under this penalty, and will hold us accountable if we fail to do so or if we do so incorrectly.

For now, I believe this is a workable delineation of our responsibilities as professionals. It may be, however, that modifications will be required down the road. On the one hand, if these provisions are nothing more than a tool for overreaching by the IRS bureaucracy, they should be cut back. On the other hand, the judgment may be made that taxpayers are continuing to play the so-called audit lottery with unabated vigor, with tax practitioners as their witting or unwitting agents. If so, it would be appropriate to revise the substantial understatement penalty by going to a strict liability sanction, an across the board "more likely than not" standard, or an across the board disclosure requirement. It may also be necessary to target additional sanctions at practitioners, for example, by way of an aid and abet negligence penalty campanion to the aid and abet fraud penalty. In may view, however, modifications to the penalty structure as they affect tax practitioners—whether to strengthen or weaken those provisions—are not appropriate at the present time.

5. *IRS research.*—The greatest frustration in any effort to develop compliance improvement measures is the substantial lack of policy relevant information. In my view, the IRS spends too small a fraction of its budget on research and development activities. While this underinvestment is necessitated by the IRS' overall lack of resources, it greatly inhibits efforts to find better ways to get the job done. The case-by-case, audit approach to compliance is necessary and effective, but other, better methods are available as well. Unless and until those concerned with administration of the system can be given more targeted and useful information, I believe your efforts to improve compliance will be substantially frustrated. TEFRA makes a start in this direction by mandating number of research projects. Many others can and should be forthcoming.

Conclusion. Once again, I thank the Committee for the opportunity to appear before you today. Please accept my apologies for belaboring withholding and the need to increase the IRS budget. While accepting that, as a political matter, neither may be doable at the present time, I think it important that we not lose sight of the fact that both are ultimately required. While the voluntary compliance system continues to function admirably, and wage withholding assures that it will continue to function reasonably well for the foreseeable future, much remains to be done. Compliance is a bipartisan issue with the taxpaying public as its constituency. Holding the line on what was done last year is a starting point. Applying those concepts to other areas in the years to come is the next step.

STATEMENT OF RONALD A. SARASIN, DIRECTOR OF GOVERNMENT RELATIONS, NATIONAL RESTAURANT ASSOCIATION, WASHINGTON, D.C.

Mr. SARASIN. Mr. Chairman, thank you very much.

As you mentioned, my name is Ron Sarasin. I am the director of Government relations for the National Restaurant Association, and with me at the table is Robert Neville, the executive vice president of the association. We certainly want to thank you for the opportunity to allow us to come in and give you some of our thoughts on the question and the aspects of tax compliance.

I want to assure you, Mr. Chairman, that we do share your goal. We are very much in favor of tax compliance as a revenue raiser; rather than the introduction of new taxes or increasing of old taxes.

I also want to assure you that we are not asking for repeal of the provisions of TEFRA which affect the restaurant industry, and we also strenuously want to assure you that we are not attempting to wiggle around or get out of an obligation to pay taxes. We believe, as you do, and we feel everyone should, that every American is re-

sponsible for paying his fair share of taxes. Interestingly enough, the tip-reporting compliance provisions of TEFRA do not speak to the restaurant industry, they speak to the employees.

We represent over 10,000 food service operators and 100,000 food service facilities that are members of our organization. Our concern is twofold: Fairness to the employees, and also fairness to the individual operator.

We have found that the burden and expense of the allocation provisions create a powerful incentive for employers to require their employees to report at least 8 percent of sales as tip income. Unfortunately, that is an incentive that is contrary to the notion of voluntary tip reporting under the Fair Labor Standards Act and also under the Internal Revenue Code.

We feel the provision regarding allocation creates most of the problems we have to live with; but in the months since TEFRA was passed, we have been heavily involved in first trying to understand and then trying to explain the effect of the law to our members.

We have come to some conclusions regarding the question of compliance, and I think, at least as this particular provisions applies to us, we have learned some lessons in how not to effect tax compliance.

One of the things we have learned is that tax compliance can't be improved if the Congress and the IRS do not understand the industry as fully as they should when tax changes are being proposed.

We feel very strongly that there is a lack of recognition on the part of the IRS because of their assumption that all restaurant servers get at least 8 percent of sales and tips. It does not recognize the diversity in the industry, and it certainly doesn't recognize the variation in tipping habits depending on locale, and so forth.

And even the possibility of proving down to 5 percent, which is allowable under the law; but, interestingly, not below that, does not go far enough. In some buffet-style dining rooms and moderate price steak houses, and so forth, the tip rate on average is less than 5 percent. And while this may surprise some people, I think we have to remember we are not saying the individual who leaves a tip leaves a 5 percent or less tip, or an 8-percent tip; we are saying that a lot of people aren't tipping at all. So your average drops, and drops considerably.

Another lesson we learned as far as tax compliance is concerned is that any change should be relatively easy to understand. And of course I use the word "relatively" advisedly when I am referring to the Tax Code, but in this situation attorneys and accountants and even the IRS people have had difficulty with the law.

For example, the Commerce Clearinghouse, CCH, just put out a book explaining the tip-reporting law. And frankly, in many places it is just plain wrong. I don't know how we would expect, the average food-service operator to be able to comply.

When we go through all of the mechanics of tip reporting and the allocation provision we end up with some numbers that the employer literally invents as a result of the allocation process. He is then required to put those numbers on a W-2 form, and the employee must try to explain to the IRS if a difference exists between what is reported in tip income and what the artificial numbers say

he should have had. This procedure shifts the burden of determining tax liability from the Government to food service employers. The shift is totally unjustifiable, since the employer doesn't know the extent of tip income received, and the allocation procedure involves a considerable amount of formulaic guesswork by an inappropriate party.

The third lesson we have learned regarding tax compliance is that education is crucial. In this situation, the public information and lack of knowledge on the part of the IRS offices on a local basis has been appalling. We at the NRA have tried to take up the slack. We have had instances where inconsistent and contrary information have come from the IRS—many instances where our members have called for help and were told to call the NRA in Washington for advice on how the law was applied.

We have, through our regular publications and news bulletins and special letters produced just to try to explain this, tried to reach our membership. We have conducted over 100 seminars in 41 States just on the issue of tip-reporting, and I might add at considerable expense.

We have responded to hundreds of requests for information. We know we didn't touch a large segment of the restaurant industry. We wonder how much compliance there will be from those we couldn't reach.

I want to assure the committee again that we do believe the tax compliance goals of the legislation can be reached. We are ready and willing to try and help on that score. We do have some problems with parts of the bill; but if compliance is to be expected, there has to be a better understanding on the part of Government, more education, and an attempt to understand the industry, as well.

Thank you very much, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL RESTAURANT ASSOCIATION

The National Restaurant Association is a nonprofit trade association with headquarters in Washington, D.C. It offers programs in public affairs, education and research to the 10,000 members, who operate more than 100,000 food service facilities.

We are pleased to be given an opportunity to comment on what Chairman Dole has termed the $100 billion taxpayer-compliance gap—the difference between federal income taxes owed and the actual amount collected each year. We have particular insight into this problem as a result of legislation enacted last year to improve compliance among restaurant tipped employees. We are referring to section 314 of the Tax Equity and Fiscal Responsibility Act of 1982—the so-called tip reporting provision.

Section 314 and proposed IRS regulations that followed in the Dec. 8, 1982, Federal Register, attempt to increase compliance among tipped employees by establishing new reporting requirements for operators as well as a minimum tip reporting threshold of eight percent for each establishment covered. Under the new law, total tips reported by employees must equal or exceed eight percent of an establishment's gross receipts, or the employer will be required to allocate additional tip income to employees to bring his establishment up to the eight percent figure. Thus, in theory, the new law ensures that tipped employees report at least eight percent of sales as tip income. It is our understanding that IRS has estimated revenue increases of $2.3 billion over a three-year period as a result of the new law.

Many members of this Committee are aware that we opposed the tip reporting provision of TEFRA when it was taken up by the Senate last year. We believed, and still hold, that the requirement that an employer ascribe additional—and, in some cases, actually not received—income to an employee is unprecedented and alien to

historical concepts in our tax code and that the new law places unjustifiable record-keeping burdens on employers.

Although we are strongly opposed to some provisions of this new law and have continued our efforts to change them, we are by no means on the side of tax dodgers and cheaters. We believe that all Americans should pay their fair share of taxes, and we also believe that increasing taxpayer compliance is preferable to raising taxes. However, we have learned a great deal since the new tip reporting provision was enacted—valuable lessons that we feel compelled to share with this Committee before it considers further legislation to improve taxpayer compliance.

Regrettably, what we have learned is how not to improve taxpayer compliance. The passage of this new law and subsequent publication of proposed regulations have brought nothing but confusion and bitterness to our members and their employees. They have found the regulations lengthy and extremely difficult to understand. They have found that the regulations do not adequately address many of the restaurant industry's peculiar problems—such as tip splitting and pooling and minimum wage regulations. They have found that local IRS offices, which many have turned to for help and advice, know little or nothing about the new law. In fact, many of these IRS offices have provided information that contradicts offices in other states or is contrary to the IRS regulations themselves. And we have found that the burden and expense of allocation creates a powerful incentive for employers to require their employees to report at least eight percent of sales as tip income—an incentive that is contrary to the notion of voluntary tip reporting under the Fair Labor Standards Act and the Internal Revenue Code.

The first lesson we would share with you, then, is that improved compliance cannot occur when Congress and IRS do not fully understand an industry affected by proposed tax changes. It is both unrealistic and unfair to assume, for example, that restaurant employees receive at least eight percent of gross receipts in tips, yet the new tip reporting law has this very expectation as its basis. The law simply does not acknowledge the great diversity in the restaurant industry or the great variation in tipping habits depending on locale and economic conditions.

There are a number of restaurants where tipping falls far short of 8 percent. Nearly one-fourth of the 1,543 respondents to a recent NRA survey reported that their tipped employees have received less than 8 percent since January 1, 1983. Under the proposed regulations, employers may reduce the eight percent threshold to not less than 5 percent by applying to their District IRS Directors. Although inclusion of this reduction correctly recognizes that not all restaurant tipped employees receive at least 8 percent in tips, it does not go nearly far enough. There are many establishments—buffet-style dining rooms, moderate-priced steak houses, lunch counters, to name just a few—where tipping is less than 5 percent yet great enough to satisfy the definition of a tipped employee under the regulations (one who receives $20 or more a month in tips).

Thus, it is not inconceivable that an employer may find himself in the untenable position of allocating additional tip income to an employee who actually has received far less than the tip threshold set for the establishment. Further compounding the problem is the fact that the appeal process for obtaining a reduction is nebulous at best. Evidence required to substantiate a reduction is not clearly spelled out, and IRS treatment of appeals on a case-by-case basis, we believe, will result in wide variance from district to district. Also disturbing is that many of our members have told us they have reached a bureaucratic dead end in their attempts to obtain an appeal.

Another lesson we have learned is that any change made in the tax code to improve compliance must be easy to understand and simple to administer. The new tip reporting law fails on both counts.

If tax attorneys, accountants and even IRS agents have difficulty understanding it, will the average operator have the foresight and patience necessary to interpret the new law? We doubt it. The new law requires that operators submit at the very least four new types of information—ranging from total charge receipts (but only those with tips on them) to total tips reported by all tipped employees.

Then there is the allocation procedure—undoubtedly the most confusing and demanding requirement under the new law. (See attached example of the seven-step IRS allocation formula.) When reported tips in an establishment fall below eight percent, the IRS regulations require that an operator perform a complicated mathematical calculation to determine each tipped employee's share of allocable tip income. The allocated amount for each tipped employee must be carried over until the end of the year and then placed on the employee's W-2 form.

We believe the allocation procedure in the IRS regulations is unworkable and should be replaced by a simplified reporting scheme. Such a change, we believe,

would make the new law less burdensome yet provide IRS with the additional revenue it seeks.

In enacting the 1965 amendments to the Internal Revenue Code, Congress decided that the only practical way to determine actual tip income for tax purposes was to require the tipped employee to report the amount received to his or her employer, and Section 6053 of the Code was added for this purpose.

We believe that satisfactory tip reporting compliance can only be achieved by ensuring the viability of Section 6053. Compliance problems cannot be solved through mandatory allocation, and we are willing to offer this Committee a method to achieve compliance goals set forth in TEFRA without resorting to allocation.

A third lesson we have learned, and would gladly share, is that taxpayer education is crucial to the success of any attempt to increase compliance. The lack of public information on the new tip reporting law and the lack of knowledge on the part of local IRS offices has been appalling. In fact, some restaurateurs have told us that they have been referred to the National Restaurant Association by the IRS because we have more information on the new law that IRS does! We find it unconscionable that the federal government would change the tax law without making any effort to educate those affected by the change. It is something akin to a restaurant menu noting there has been a change in the "special of the day" but failing to indicate what it is.

For our member's sake, we have tried to provide restaurateurs with the most complete and up-to-date information possible on the new tip reporting law. We have used our regular publications, plus special bulletins and newsletters produced especially for this purpose. We have also put on—at great expense—over 100 seminars on tip reporting in some 41 States. In addition, our staff has answered literally hundreds of telephone and written queries from restaurateurs.

We cannot help but wonder, however, how those operators not affiliated with our association will fare under the new law. Lack of adequate preparation for the changes, we feel, will undoubtedly undercut much of the new revenue IRS is expected to realize.

Finally, this law shifts the burden of determining tax liability from the government to foodservice employers. This shift is totally unjustifiable since the employer does not know the extent of tip income received. The allocation procedure involves a considerable amount of formulaic guesswork by an inappropriate party.

In summary, we support and encourage increased taxpayer compliance, provided it does not force individuals to pay taxes on income they have not received, it does not violate other laws and regulations and it does not pose an unreasonable record-keeping burden. A realistic, reasonable, well-informed approach to regulations is critical to increased taxpayer compliance, and we are anxious to join you in working toward this end.

HOURS-WORKED METHOD

Directly Tipped Employees	Hours Worked in Payroll Period	Tips Reported
A	180	$1,080
B	172	880
C	188	1,810
D	176	800
E	144	450
F	160	680
	1020	$5,700

The allocation computations would be as follows:
(1) $100,000 (gross receipts) × 0.08 = $8,000
(2) Tips reported by indirectly tipped employees = $500
(3) $8,000 - $500 (indirect employees' tips) = $7,500

(4)

Directly Tipped Employees	Directly Tipped Share of 8% Gross		Hours Worked Ratio		Employee Share of 8% Gross
A	$7,500	×	180/1020	=	$1,324
B	7,500	×	172/1020	=	1,265
C	7,500	×	188/1020	=	1,382
D	7,500	×	176/1020	=	1,294
E	7,500	×	144/1020	=	1,059
F	7,500	×	160/1020	=	1,176
					$7,500

(5)

Directly Tipped Employees	Employee Share of 8% Gross	Tips Reported	Employee Shortfall
A	$1,324	$1,080	$ 244
B	1,265	880	385
C	1,382	1,810	—
D	1,294	800	494
E	1,059	450	609
F	1,176	680	496
	$7,500	$5,700	$2,228

Since employee C has no reporting shortfall, there is no allocation to C.

(6) $8,000 - 6,200 (total tips reported) = $1,800 (amount allocable among shortfall employees).

(7)

Shortfall Employees	Allocable Amount	Shortfall	Amount of Ratio		Allocation
A	$1,800	×	244/2228	=	$197
B	1,800	×	385/2228	=	311
D	1,800	×	494/2228	=	399
E	1,800	×	609/2228	=	492
F	1,800	×	496/2228	=	401

GROSS-RECEIPTS METHOD

Directly Tipped Employees	Gross Receipts for Payroll Period	Tips Reported
A	$18,000	$1,080
B	16,000	880
C	23,000	1,810
D	17,000	800
E	12,000	450
F	14,000	680
	$100,000	$5,700

The allocation computations would be as follows:
(1) $100,000 (gross receipts) × 0.08 = $8,000
(2) Tips reported by indirectly tipped employees = $500
(3) $8,000 - $500 (indirect employees' tips) = $7,500

(4)

Directly Tipped Employees	Directly Tipped Share of 8% Gross		Gross Receipts Ratio		Employee Share of 8% Gross
A	$7,500	×	18,000/100,000	=	$1,350
B	7,500	×	16,000/100,000	=	1,200
C	7,500	×	23,000/100,000	=	1,725
D	7,500	×	17,000/100,000	=	1,275
E	7,500	×	12,000/100,000	=	900
F	7,500	×	14,000/100,000	=	1,050
					$7,500

(5)

Directly Tipped Employees	Employee Share of 8% Gross	Tips Reported	Employee Shortfall
A	$1,350	$1,080	$ 270
B	1,200	880	320
C	1,725	1,810	—
D	1,275	800	475
E	900	450	450
F	1,050	680	370
	$7,500	$5,700	$1,885

Since employee C has no reporting shortfall, there is no allocation to C.

(6) $8,000 - 6,200 (total tips reported) = $1,800 (amount allocable among shortfall employees).

(7)

Shortfall Employees	Allocable Amount	Shortfall	Amount of Ratio		Allocation
A	$1,800	×	270/1885	=	$258
B	1,800	×	320/1885	=	306
D	1,800	×	475/1885	=	454
E	1,800	×	450/1885	=	430
F	1,800	×	370/1885	=	353

The CHAIRMAN. I think one point, I guess, is where some say it's too high, there are others who say it's too low. So maybe we could pick up the revenue we lose if we lower it by raising it in other restaurants. Would you have any objection to that?

Mr. SARASIN. I am not sure I understand the Chairman's question.

The CHAIRMAN. Well, some family style restaurants have complained that the 8-percent threshhold for allocating estimated unreported tip income is too low for the luxury white-tablecloth restaurants, and I just suggest maybe we could respond to that criticism if we used a charged charge-tip rate, and I understand that that change might produce as much as $1 billion in additional receipts over the next 3 years.

Mr. SARASIN. In discussions with your staff, Senator, that suggestion has been made.

The CHAIRMAN. Do you object to that, or do you support that?

Mr. SARASIN. We are attempting to respond to that. There are some problems with it. When you use the charge-tip rate, there is an assumption that there is a close relationship between cash tips and charge tips, which I don't think holds over the long run. Beyond that, how do you use the charge-tip rate?

Charged tips, as the IRS regulations require them to be reported under TEFRA—you are required to report your charged tips, but only those slips with tips on them, which overlooks the whole situation, where patrons simply won't tip. And yet that part of it is shoved aside; it is not even counted. It distorts the ratios and skews the results. So I think charge-tips conceptually might be possible, but a great deal of definition would have to go into it first.

I think we should remember, if I may, Senator, the allocation process which causes the problems for employee and employer alike hits the lower end of the restaurant scale. If there are dollars that are out there that are not being reported, frankly, it is in the higher end of the restaurant scale. And what we are saying is—and what we would suggest is—a better way to handle this would be to provide more information than IRS has today; we would be willing to give them the numbers so that they can make a decision as to whether they think something is out of line or something is wrong, to give them the opportunity to go after it.

But the idea of inventing numbers that the employee then has to explain or somehow try to live with as far as the IRS is concerned is, we think, the wrong way to go about it.

The CHAIRMAN. Well, we will continue to work with the NRA and others. There are other groups, too, who have concerns about tip reporting. Again, it is the same principle, as far as I'm concerned. If it should be changed, we will try to change it. But if it means we are going to lose all the revenue in the process, then we will find some substitute to pick it up. I can think of a couple that would pick it up and add, a couple you don't like.

Mr. SARASIN. We don't disagree with the Chairman at all.

The CHAIRMAN. I think the three-martini lunch amendment is still very viable and would pass without much difficulty.

So let's try to work it out.

Mr. SARASIN. Right.

We would expect, Senator, to continue the dialog we have started and try and reach an agreement. We don't expect any revenue loss. We are not asking for a revenue loss.

The CHAIRMAN. Well, we understand your proposal would take at least half the revenue.

Mr. SARASIN. Well, that is new information to us, Senator. We have asked your staff to try and run the numbers on the proposal we have made on alternative and additional reporting, and we have not been given any numbers in that regard. But I certainly would like to have a chance to see them.

The CHAIRMAN. Right. No doubt about it, there are some areas that probably should be modified. We at the staff level have been visiting IRS. I visited with Mr. Egger before he was hospitalized.

I think also it is going to take a little time to work out the bugs. It has only been effective since April 1, and on April 2 we had this group wanting to change it—in effect in 1 day. I think it is going to take a little while, as you said, through education and information, to really know what we need to change. Maybe there are some changes that should be made.

Mr. SARASIN. If the Senator will allow me, the opportunity we have had as a trade association trying to get the information out to our people has put us in a unique position. We have had a chance to listen to a lot of people and to direct our attention to this one small part of TEFRA, while obviously the Senate and your committee have had to deal with the reaction to the whole bill.

The CHAIRMAN. I have seen some of the complicated instructions. I don't know how you would figure it out. I don't care which restaurant you owned, it would be a nightmare. So, there is no doubt about it, there are some problems. We want to try to address those problems, but we don't want to lose sight of our obligation. It doesn't make any difference to me. Our obligation is to collect taxes that are due, and I'm not going to give up on that obligation. It seems to me that's only fair to the other taxpayers.

Now, if there is a better way to do it—you may have a better way that we can collect more money from taxes that aren't being paid in the restaurant industry.

I think a great many people report their income—waiters and waitresses.

Mr. SARASIN. I agree.

The CHAIRMAN. I don't quarrel with that. They don't need this. But there are some who don't. I think the compliance rate is estimated to be 14 percent, prior to TEFRA. So it's one of the lowest areas.

Mr. SARASIN. We would argue with that percentage.

The CHAIRMAN. Well, make it 30 percent. It would still be very low.

Mr. SARASIN. Mr. Chairman, there is a defect here, a deficiency in the compliance rate. We are aware of that. We think we can get at that. The question is: How do we effect compliance? How do we live with it without creating an intolerable burden? How do we do it without creating a situation of dissent between the employer and the employee? It has created a serious management problem, and that is what we are trying to work out.

The CHAIRMAN. No doubt about it. I have been subject to substantial criticism. I don't know if the restaurant industry is behind it.

Mr. SARASIN. I assure you the NRA has nothing to do with those buttons.

The CHAIRMAN. There are a lot of resourceful people out there.

So we are looking at it, but, again, we have seen about $8 billion slip away through repeal of withholding over the next 5 years. We could lose another $4 billion in tip reporting, and we are told we ought to cap the third year for taxpayers who pay their taxes, to collect $6 billion. It doesn't make any sense to me that we should raise your taxes if somebody else doesn't have to pay any.

Mr. SARASIN. We agree with you, Senator.

The CHAIRMAN. I haven't quite. We will continue to see what happens.

Mr. SARASIN. Thank you very much.

The CHAIRMAN. If there are other witnesses who would like to submit statements, who are not on the witness list, certainly the record is open. Or if anyone would like to comment on any testimony, certainly that opportunity is available.

There will be a hearing tomorrow at 9:30 a.m. in the tax shelter area. It will be chaired by Senator Grassley, chairman of that committee. And then I guess we will be having hearings on the 28th and the 29th on tax preferences generally.

I would say again for the record, it is not because we enjoy doing this, it is because we may be mandated by the Congress to raise $73 billion in revenue over the next 3 years. So I think that's an obligation we may have; although I must say I think the budget resolution is simply a tax increase with no spending reductions, so it may not pass.

Thank you.

[Whereupon, at 1:22 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF HENRY W. ELOCH, PRESIDENT OF H & R BLOCK, INC.

Mr. Chairman and members of the subcommittee: I appreciate the opportunity to submit this statement for the official record of your June 23, 1983, hearing on your efforts to reduce the $100 billion annual tax compliance gap and to address the role of tax professionals in improving tax compliance efforts.

We recognize the magnitude of the tax gap problem and its implications for our tax system and our budget deficits. We think the penalty provisions of last year's far-reaching Tax Equity and Fiscal Responsibility Act [TEFRA] will help narrow the gap. We think that two other approaches are necessary to narrow the tax gap even more. One, which is obvious and requires no elaboration, is to increase the Internal Revenue Service resources devoted to compliance and enforcement programs. The second approach is somewhat innovative and simple but worth your serious consideration.

As you know, a deduction for tax return preparation expenses is available to those taxpayers who file returns claiming itemized deductions. This encourages taxpayers to seek professional tax help, thereby helping them comply with the tax laws. But a similar tax assistance benefit is not available to those who do not itemize deductions—usually lower income taxpayers and those who are least able to understand and comply with the tax laws. Millions of our clients view this as a glaring inequity. It undoubtedly is one contributing factor to the non-compliance problem which you are addressing in this hearing.

A fair solution to this inequity while at the same time helping all taxpayers to comply with the tax laws is to grant a small tax credit to all taxpayers for tax prep-

aration expenses. Any costs exceeding the small credit should be deductible, as now allowed by those who itemize deductions.

It is by now universally recognized that voluntary compliance is vital to the health of the income tax system and that the system be perceived by all taxpayers (those with smaller incomes as well as those with larger incomes and those who understand the ever-more-complex law and those who don't understand it) as one which has the fundamental objective of fairness and evenhanded treatment of all taxpayers. It is unjust and incomprehensible to the taxpayer who files the two-page Form 1040A or who files a Form 1040 but does not itemize, that he or she is not entitled to a tax benefit for the expenses incurred in having his or her return prepared by professional preparers.

Quite aside from the inequity of the situation, practical compliance advantages to the Government should result from an amendment to the Internal Revenue Code providing for such a benefit. Some, but not all, of the compliance and other related advantages would seem to be as follows:

1. Assistance from qualified tax return preparers will help insure the preparation and filing of returns that generally are, and should continue to be more accurate than those prepared by taxpayers themselves. A credit will encourage taxpayers to seek assistance from qualified preparers which should improve compliance and the functioning of the entire system.

2. The success of the American tax system is dependent to a great extent on voluntary compliance. Such voluntary compliance would be enhanced as a result of the adoption of this benefit with more revenue received by the Government including some reduction in the tax loss from the so-called underground economy.

3. If tax withholding on interest and dividends becomes a fact, or if additional compliance requirements and backup withholding is legislated, taxpayers will have heavier compliance burdens.

The assistance of professional preparers should decrease the compliance burden of taxpayers and result in fewer errors on returns filed, thus also decreasing the IRS processing and compliance efforts.

4. Such a credit which encourages taxpayers to use qualified tax return preparers should have the additional benefit of providing peace of mind to taxpayers that they have complied with the law—not under or overreported their tax obligations—and that if and when audited, they would be accompanied by a qualified individual with supporting data.

5. Since the provision for the new credit should encourage taxpayers to seek private sector assistance in lieu of visiting or telephoning offices of the Internal Revenue Service, it would help reduce the IRS taxpayer assistance budget and make more resources available for compliance and enforcement activities.

6. Public confidence in the tax system would increase, especially on the part of the lower income taxpayers who do not understand the law and therefore may not be able to comply with it. They are concerned with obtaining reliable advice but often cannot afford to do so. Since many of these taxpayers view the Internal Revenue Service as an enforcement agency, to them information received from the IRS is therefore suspect. The only real choice for many of them is a reliable tax return preparer.

In summary, public policy reflected in the Internal Revenue Code for many years is intended to encourage the use of paid tax preparation assistance for itemizing taxpayers who are usually higher income taxpayers. The tax savings from such a policy until recently were worth as much as 70 percent of the fees paid to preparers and are worth as much as 50 percent under current law.

Such a policy should be applicable to all taxpayers. It may even be argued that from a public interest standpoint it is even more important to have the policy apply to lower income taxpayers since they are frequently the ones who find it difficult to understand and comply with the tax laws, are uncertain about what income is reportable and taxable, are unable to deal with the forms themselves and can least afford to pay for tax preparation help. Millions of individuals file forms 1040A or 1040EZ and numerous others do not itemize deductions. They deserve the same benefit and incentive to seek competent tax preparation assistance from the private sector as the itemizing taxpayer.

A reduction in the tax compliance burden for non-itemizing taxpayers and equal access to tax preparation assistance for all taxpayers would be best achieved by a tax credit for income tax preparation fees.

I respectfully request that you introduce a bill which would allow a $25 tax credit for everyone regardless of the tax form used with any expenses incurred for tax preparation fees over the $25 credit being allowed as a deduction for those who itemize deductions. This would help substantially the masses of taxpayers to comply

with our tax laws without giving any significant added benefit to those with high incomes. The relatively minor added tax expenditure resulting from this credit would much more than be offset by the additional revenue recovered from improved compliance.

I would be pleased to discuss this in greater detail with you or a member of your staff.

INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA—UAW,
Washington, D.C., June 21, 1983.

Hon. ROBERT J. DOLE,
Chairman, Committee on Finance, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Although it will not be possible for the UAW to testify at the hearing on June 23, 1983, concerning the proposed $700 "cap" on the third year of the personal income tax cut, we wish to state our strong support for this proposal. We ask that this communication be made part of the Finance Committee's hearing record.

Imposing a cap on the third year of the tax cut so that no taxpayer will receive more than $700 will have little or no impact on taxpayers with incomes below $45,000. They will still receive the full amount of the tax cut scheduled to go into effect on July 1, 1983. The only difference would be for the top 5 percent of taxpayers with incomes above $45,000, whose tax cut would be limited to a maximum of $700.

The UAW strongly opposed the Reagan tax cut when it was first proposed because we believed then, and still do, that it was badly misdirected and regressive in its application. In our judgment, it did not do enough for those who needed help the most and too much for those who needed it not at all. In the process, essential revenue has been denied to critically-important human needs programs, and deficits have risen to record levels.

The proposal to place a $700 cap on the third year of the tax cut would begin to address these problems. It would eliminate some of the unfairness in the tax cut. It would save $6 billion over the next year, and a total of $20 billion over three years. And, because most taxpayers would still receive the full amount of the tax cut, it would not reduce consumer demand or otherwise impede economic recovery.

The UAW therefore believes that the proposal to place a $700 cap on the third year of the tax cut represents sound fiscal policy. We believe it deserves the enthusiastic support of Congress.

Sincerely,

DICK WARDEN,
Legislative Director.

STATEMENT BY DAVID L. KEATING, EXECUTIVE VICE PRESIDENT, NATIONAL TAXPAYERS UNION

The National Taxpayers Union, representing over 120,000 taxpayers in all 50 states, strongly opposes placing a $700 "cap" on the third year of the personal income tax rate reduction.

This "cap" would increase taxes for 14.5 million voting age citizens. Its effect is similar to that of a surtax. But virtually all of this surtax would only apply to taxable incomes earned between $85,200 and $109,400 for joint returns, and between $28,800 and $53,000 for single returns.

The most important effect of the 1981 tax reduction bill was to bring marginal tax rates down. A $700 "cap" would seriously distort that vital tax rate reduction plan by introducing a large jump in marginal tax rates from 30 percent to 38 percent at $28,000 of taxable income for single taxpayers. For married taxpayers filing jointly, the marginal tax rate would jump from 28 to 37 percent at a taxable income of $35,200.

Dramatically boosting marginal tax rates is one of the most harmful ways to raise revenues. Passage of this "cap" will jeopardize economic recovery, which is only now beginning to reduce high levels of unemployment.

Passage of the "cap" would send a message to taxpayers across the country that the Congress will not vote to limit Federal spending, preferring instead to increase taxes in a hasty, patchwork manner.

It's also poor tax policy for Congress to consider a tax increase which would go into effect in less than 2 weeks. How can taxpayers possibly make sound economic and financial decisions without reasonable certainty of the tax rates they can expect?

Finally, approximately two-thirds of the wage earners who would have their taxes increased by this proposal are married with a working spouse. In 1981, Congress wisely enacted relief from the "marriage tax penalty." A substantial amount of this relief would be taken away if the $700 "cap" passes.

We strongly urge the Committee to reject this misguided tax increase and any other proposals to weaken the third year of the tax rate reduction or indexing. The proper way to control the Federal deficit is to limit and reduce Federal spending.